

# Redesigning the Earned Income Tax Credit as a Family-Size Adjustment to the Minimum Wage

LAWRENCE ZELENAK\*

## I. INTRODUCTION

From modest beginnings in 1975, the earned income tax credit (EITC) has grown into the largest federal anti-poverty program, with an annual cost of well over \$30 billion.<sup>1</sup> With its focus on providing benefits to low-wage workers and their dependent children, the credit has been popular with both conservatives (for conditioning eligibility on the existence and amount of earned income), and liberals (for its redistributive effects). Despite the political success of the EITC, the credit remains severely undertheorized. Although Congress has revised the credit a number of times, it has never accompanied those revisions with legislative history explaining the purpose of the credit, except in the vaguest and most general terms. There is a substantial scholarly literature on the EITC, but for the most part it also fails to offer complete accounts of what the credit is (or should be) designed to accomplish. Without a clear idea of what the EITC is supposed to do, it is impossible to determine how it should be designed. In particular, it is impossible to decide how the number of the claimant's dependent children should affect the credit calculation, how to phase in the credit for workers at very low income levels, how (if at all) to phase out the credit for higher wage workers, and how the credit design can be fair to both married and unmarried claimants.

This Article provides a conceptual framework for the EITC—it offers an account of what the EITC should be designed to accomplish, and considers how to redesign the credit to achieve the intended results. In the absence of any definitive statement of legislative purpose, or any coherent purpose discernible from the structure of the credit, the approach is necessarily intuitive. The assumption is that inside the

---

\* Pamela B. Gann Professor of Law, Duke Law School.

<sup>1</sup> In 2003, the total cost to the government of the EITC program was \$33 billion. Joint Comm. on Tax'n, 108th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008, at 33 tbl.3 (Comm. Print 2003). The \$33 billion amount includes both credits used to reduce income tax liability and refundable credits (that is, credits in excess of income tax liability).

somewhat incoherent design of the EITC is a coherent structure struggling to emerge, and the goal is to understand that inchoate EITC.

Not to keep the reader in suspense, the Article's claim is that the EITC can and should be revised to function as an adjustment to the minimum wage based on family size, designed to ensure that no family headed by a working parent lives in poverty, regardless of the number of children in the family.<sup>2</sup> The Article considers in detail how to restructure the credit in keeping with this goal. In addition to proposing a normative view of the EITC and statutory revisions in keeping with that view, the Article has a second purpose—to encourage others to offer other accounts of the purposes of the credit, and to explain how those accounts would affect the credit's design. The hope is that the resulting dialogue might lead to improvements in the structure of the EITC, some current aspects of which seem inexplicable under any conceivable rationale.

The Article proceeds as follows. Section II provides a brief history of the EITC, a description of the current rules, and descriptions of two other tax benefits for parents with dependent children (the child tax credit and the dependency exemption). Section III claims that the EITC can and should serve as an adjustment to the minimum wage based on family responsibilities, and considers how the maximum credit amount and the credit phase-in rules should be revised in keeping with that purpose. This Section also considers how the design of the credit might be influenced by the existence of other tax and transfer programs relevant to low wage families—in particular the Social Security payroll tax and food stamps. Section IV considers whether a phasing out of the credit is necessary, and if so how the phase-out should be designed. Section V discusses problems of marriage and singles penalties under the proposed version of the credit. Section VI is a conclusion. In addition, an appendix describes two historical antecedents for the proposed version of the EITC—one from 18th century England, and one from early 20th century United States.

## II. HISTORICAL AND STATUTORY BACKGROUND

### A. *A Brief History of the EITC*

Milton Friedman's 1962 proposal for a negative income tax first put the use of the federal income tax to make transfer payments to those with little or no income on the public policy agenda.<sup>3</sup> Friedman ob-

---

<sup>2</sup> The germ of this concept of the EITC appears in Lawrence Zelenak, *Children and the Income Tax*, 49 *Tax L. Rev.* 349, 401-04 (1994) [hereinafter *Children*].

<sup>3</sup> Milton Friedman, *Capitalism and Freedom* 191-92 (2d prtg. 1982). This Article's Appendix describes two other, much earlier, intellectual precursors of the EITC—the Speenhamland system of late 18th and early 19th century England, and a 1925 proposal by Paul

served that the tax system could recognize the existence of negative amounts of taxable income. For example, if a person had gross income (from wages) of \$4,000, and the sum of her standard deduction and personal exemptions was \$10,000, her taxable income could be defined as  $-\$6,000$  (rather than as simply zero). Friedman proposed applying a “tax” rate of 50% to negative income, so that a person with taxable income of  $-\$6,000$  would be entitled to a \$3,000 payment from the government. If a person had no gross income, her taxable income would be  $-\$10,000$  (or whatever the sum of her standard deduction and exemptions happened to be), and she would receive the maximum transfer payment of \$5,000.<sup>4</sup> Although Friedman conceptualized his proposal as a negative tax on below-zero taxable income, it just as well could be described as a \$5,000 guaranteed annual income, with the \$5,000 maximum transfer amount phased out at the rate of 50% as gross income rose above zero.

If the sum of a person’s standard deduction and exemptions equaled the poverty level, the Friedman approach would guarantee an income equal to only 50% of the poverty level. Others followed with more ambitious plans for the government to make up the difference between a person’s income (if any) and the official poverty level.<sup>5</sup> Under these proposals, a person with no income would receive a grant equal to the cost of subsistence, and the amount of the grant would be reduced dollar-for-dollar (that is, phased out at the rate of 100%) as income rose above zero. Although these proposals were expressed as income guarantees rather than as negative income taxes, the only substantive differences between them and the Friedman proposals were (1) the larger amount of the maximum transfer (100% rather than 50% of the cost of subsistence) and (2) the higher phase-out rate (100% rather than 50%).

Influenced by Friedman, the Nixon administration proposed the “Family Assistance Plan” (FAP) in 1969. Although the proposal envisioned that unemployed FAP beneficiaries would have to demonstrate they were attempting to find work, the FAP was basically a guaranteed annual income, based on family size and featuring a phase-out rate of 50%.<sup>6</sup> The proposal eventually was defeated; the politically

---

H. Douglas. Unlike Friedman’s proposal, however, these earlier precursors had no influence on the enactment of the EITC in 1975.

<sup>4</sup> Id. at 192.

<sup>5</sup> E.g., Robert Theobald, *Free Men and Free Markets* 145-47 (1963); Edward E. Schwartz, *A Way to End the Means Test*, *Social Work*, July 1964, at 3, 4-5.

<sup>6</sup> See Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, in *Making Work Pay: The Earned Income Tax Credit and its Impact on America’s Families* 15, 19-23 (Bruce D. Meyer & Douglas Holtz-Eakin eds., 2001).

decisive objections were that a guaranteed income would reward the idle, and that the high phase-out rate would penalize and discourage work effort.<sup>7</sup>

In 1972, following the defeat of the FAP proposal, Senator Russell Long suggested a different way to use the income tax system to make anti-poverty transfer payments. Long's proposal was for a "work bonus," a credit equal to 10% of the first \$4,000 of earned income, with the credit phased out at the rate of 25% as earned income rose above \$4,000.<sup>8</sup> Under Long's approach, a person with no earnings would receive no bonus, a person with \$4,000 of earnings would receive the maximum bonus of \$400, and a person with earnings of \$5,600 or more would receive no bonus. The most striking difference between the work bonus and its FAP predecessor was that the work bonus was available only to the "deserving poor," with dessert established by earned income. Under the FAP, the existence of earned income reduced the amount of the transfer, but under the work bonus the first few thousand dollars of earned income increased the amount of the transfer.

The restriction of benefits to the deserving (that is, working) poor under the Long proposal proved to be crucial to the political acceptability of using the income tax to make anti-poverty transfer payments. The first EITC, enacted in 1975 as a temporary measure, closely resembled Long's proposal.<sup>9</sup> The credit equaled 10% of the first \$4,000 of earned income, and was phased out at the rate of 10% as income increased above \$4,000 (with the phase-out completed at \$8,000). The credit was available only to workers with dependent children, but beyond that the credit was not sensitive to family size. According to the legislative history, the purposes of the EITC included encouraging employment, reducing welfare rolls, and offsetting the burden of the payroll tax.<sup>10</sup> The EITC was made permanent, and modestly enlarged (in response to inflation) in 1978.<sup>11</sup> It was modestly enlarged again in 1984,<sup>12</sup> and once more in 1986, when it also was indexed for inflation.<sup>13</sup>

Legislation in 1990 introduced a distinction between EITC recipients with only one child, and those with two or more children.<sup>14</sup> The

---

<sup>7</sup> Id. at 22.

<sup>8</sup> Id.

<sup>9</sup> Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30-32.

<sup>10</sup> S. Rep. No. 94-36, at 33 (1975), reprinted in 1975-1 C.B. 590, 595; H.R. Rep. No. 94-19, at 10 (1975), reprinted in 1975-1 C.B. 569, 573-74.

<sup>11</sup> Revenue Act of 1978, Pub. L. No. 95-600, §§ 103, 104, 92 Stat. 2761, 2770-71.

<sup>12</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1042, 98 Stat. 494, 1043-44.

<sup>13</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, § 111, 100 Stat. 2085, 2107-08.

<sup>14</sup> Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11, 111, 104 Stat. 1388, 1388-408-13.

distinction was small, however. The 1990 legislation provided a 25% credit for claimants with two or more children, compared with a 23% credit for claimants with only one child.<sup>15</sup> The basic structure of the current EITC—including both a two-child credit significantly larger than the one-child credit, and a small credit for childless workers—was introduced in 1993.<sup>16</sup> The Ways and Means Committee report offered a rather vague explanation for the larger two-child credit: “Providing a larger basic EITC to larger families recognizes the role the EITC can play in alleviating poverty. Moreover, this larger credit may provide work incentives and increase equity by reducing the tax burden for those workers with a lower ability to pay taxes.”<sup>17</sup> The report does not explain why it was not also appropriate to distinguish between workers with exactly two children, and workers with three or more children. As for the no-child credit, the report explained: “[T]he committee believes that extending the EITC to low-income working taxpayers without qualifying children will provide those taxpayers with an additional benefit for entering the labor force and reduce the burden of the individual income and payroll taxes on those with a lower ability to pay taxes.”<sup>18</sup> Although not mentioned in the report, the 7.65% phase-in rate of the no-child credit was (and is) identical with the rate of the employee’s share of the payroll tax.<sup>19</sup>

*B. Current Law: The EITC, the Child Tax Credit, and the Dependency Exemption*

The EITC is a refundable credit; if the amount of the credit exceeds the claimant’s precredit federal income tax liability, the claimant receives the excess amount as a transfer payment. The amount of the credit depends on the taxpayer’s earned income and adjusted gross income (AGI), and on the number of “qualifying children” of the taxpayer. In general, a qualifying child is a child who lives with the taxpayer, who is under the age of 19, and who is the taxpayer’s child (or other direct descendant), sibling, or foster child.<sup>20</sup>

<sup>15</sup> Id. at 1388-409. The phase-in range and the phase-out thresholds were identical for the 25% and 23% credits, while the phase-out rate was slightly higher for the 25% credit.

<sup>16</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,131, 107 Stat. 312, 433-35.

<sup>17</sup> H.R. Rep. No. 103-111, at 609 (1993), reprinted in 1993-3 C.B. (vol. 1) 163, 180.

<sup>18</sup> Id.

<sup>19</sup> The 7.65% employee payroll tax consists of a 6.2% tax to finance Social Security benefits, IRC § 3101(a), and a 1.45% tax to finance Medicare, IRC § 3101(b)(6).

<sup>20</sup> IRC § 32(c)(3).

For a childless taxpayer,<sup>21</sup> the credit is phased in at the rate of 7.65% over the first \$5,100 of earned income, producing a maximum credit of \$390.<sup>22</sup> The no-child credit is reduced by 7.65% of the amount by which AGI exceeds \$6,390 (or \$7,390, in the case of a joint return), resulting in elimination of the credit at AGI of \$11,490 (or \$12,490 for a joint return). For a taxpayer with one qualifying child, the credit is phased in at the rate of 34%, reaching a maximum of \$2,604 at earned income of \$7,660. The 15.98% phase-out of the one-child credit begins at \$14,040 AGI (\$15,040, in the case of a joint return), and is completed at \$30,338 (\$31,338 for a joint return). For a claimant with two or more qualifying children, the maximum credit amount of \$4,300 is reached by phasing in the credit at the rate of 40% over the first \$10,750 of earned income. The 21.06% phase-out begins at AGI of \$14,040 (\$15,040, in the case of a joint return), and the credit is eliminated at AGI of \$34,458 (\$35,458 for a joint return).

The EITC is one of three major income tax benefits for parents with dependent children, which are based on the dependency relationship itself rather than on proof of expenditures of particular dollar amounts for particular purposes.<sup>23</sup> Unlike the EITC, which is aimed at low-wage working parents, the other two provisions primarily benefit middle-income parents. These two provisions are described here because a subsequent Section considers the possibility of integrating the two provisions with the EITC.<sup>24</sup>

The child tax credit (CTC), first enacted in 1997,<sup>25</sup> currently equals \$1,000 for each “qualifying child” (generally, a dependent of the taxpayer, age 16 or younger).<sup>26</sup> Unlike the EITC, the CTC imposes no ceiling on the number of children who may be taken into account in determining the total amount of a taxpayer’s credit.<sup>27</sup> The credit is refundable to the extent of 15% of the amount by which the tax-

---

<sup>21</sup> The no-child EITC is available only to workers older than 24 and younger than 65. IRC § 32(c)(1)(A)(ii)(II).

<sup>22</sup> IRC § 32(b)(1)(3). All descriptions in this section reflect the inflation adjustments for 2004. Rev. Proc. 2003-85, § 3.06(1), 2003-49 I.R.B. 1184, 1187.

<sup>23</sup> By contrast, the child care credit, IRC § 21, and the exclusion for benefits received under dependent care assistance programs, IRC § 129, depend on proof of child care expenditures (or the receipt of child care benefits in kind, in the case of IRC § 129).

<sup>24</sup> Text accompanying notes 124-39.

<sup>25</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 101, 111 Stat. 788, 796-99 (adding IRC § 24).

<sup>26</sup> IRC § 24(a).

<sup>27</sup> A taxpayer with a large family may not be able to claim a credit equal to \$1,000 multiplied by the number of dependent children, because of the general rule that the credit is not refundable. But see IRC § 24(d), described in the text following this note, providing for partial refundability of the CTC for some taxpayers.

payer's earned income exceeds \$10,750.<sup>28</sup> The phase-in of CTC refundability operates as a 15% negative marginal tax rate, over much of the same income range as the phase-out of the EITC. Thus, for a taxpayer with two children, subject to both the 21.06% phase-out tax of the EITC and the negative 15% phase-in tax of the CTC, the net effect of the two provisions is a marginal tax rate of 6.06%.<sup>29</sup> Although the phase-in of CTC refundability tends to lessen the burden of the EITC phase-out, the two provisions are far from perfectly offsetting. Most obviously, the one-child and two-child EITC phase-out rates are higher than the CTC refundability phase-in rate. In addition, the EITC phase-out and CTC phase-in income ranges, although overlapping, are not identical.<sup>30</sup> Finally, because of different age limits for qualifying children under the two provisions, some taxpayers subject to the EITC phase-out will not be eligible for the CTC refundability phase-in.<sup>31</sup>

The CTC is phased out for higher income taxpayers. The phase-out reduces the CTC by 5% of the amount by which AGI exceeds \$75,000 (or \$110,000, in the case of a joint return).<sup>32</sup> If a taxpayer has more than one qualifying child, the phase-outs of the credits for the different children operate consecutively, rather than concurrently.<sup>33</sup> For example, a husband and wife with two children and AGI of \$114,000 are entitled to a CTC of \$1,800,<sup>34</sup> not \$1,600.<sup>35</sup>

The dependency exemption of § 151 reduces a taxpayer's taxable income by \$3,100 for each dependent child.<sup>36</sup> Like the CTC and unlike the EITC, the exemption provision imposes no ceiling on the

---

<sup>28</sup> IRC § 24(d); Rev. Proc. 2003-85, note 22, § 3.04, at 1187 (inflation adjustment for 2004). The refundability calculation operates on a per taxpayer basis, rather than a per child basis. Thus, a taxpayer with earned income of \$13,750 and two qualifying children is entitled to only \$450 of refundable child credit, not \$900.

<sup>29</sup> This, of course, does not take into account marginal tax rates arising from other sources, such as the regular income tax rate schedules of IRC § 1, and the payroll tax.

<sup>30</sup> Even if the CTC refundability phase-in and EITC phase-out income ranges were numerically identical (which they are not), there would be a residual difference because the CTC phase-in is based on earned income, IRC § 24(d)(1)(B)(i), whereas the EITC phase-out is generally based on AGI, IRC § 32(a)(2)(B).

<sup>31</sup> A parent may claim the EITC but not the CTC for a child age 17 or 18. Compare IRC § 24(c)(1) with IRC § 32(c)(3).

<sup>32</sup> IRC § 24(b).

<sup>33</sup> Joint Comm. on Tax'n, 105th Cong., General Explanation of Tax Legislation Enacted in 1997, at 7 (Comm. Print 1997). The statute itself is ambiguous on this question, but the Service follows the approach indicated by the Bluebook. See IRS, Child Tax Credit (Publication 972), at 4 (work sheet), available at <http://www.irs.gov/pub/irs-pdf/p972.pdf>.

<sup>34</sup> The pre-phase-out credit amount of \$2,000, reduced by  $(\$114,000 - \$110,000) \times 5\% = \$200$ .

<sup>35</sup> A CTC of \$1,600 would be the result if the phase-out reduced each of the two \$1,000 credits by \$200.

<sup>36</sup> IRC § 151(c); Rev. Proc. 2003-85, note 22, § 3.16(1), at 1188 (inflation adjustment for 2004).

number of children with respect to whom exemptions may be claimed.<sup>37</sup> Congress apparently intended the exemption amount to approximate the cost of supporting a child at the poverty level.<sup>38</sup> Because the exemption functions as a deduction, the tax reduction from the exemption equals the amount of the exemption multiplied by the taxpayer's marginal tax rate. The exemption is of no value to a parent whose taxable income would be zero even in the absence of the exemption.<sup>39</sup>

For most of the history of the federal income tax, parents at all income levels were allowed to claim dependency exemptions. Allowing exemptions to middle- and high-income parents is appropriate under the "clear income" theory of taxable income. The idea is that ability to pay tax is generated only by clear income—the amount by which a taxpayer's income exceeds his family's poverty level. Since the poverty level is a function of family size, even a millionaire should be entitled to dependency exemptions, in order to determine the amount of his clear income.<sup>40</sup> Thus, dependency exemptions can be used to reflect differences in taxpaying abilities based on differences in family size, at all points in the income distribution.

The current version of the exemption provision, however, represents a rejection of the clear income concept. Under § 151(d)(3), exemptions are phased out for high-income taxpayers. For married taxpayers filing a joint return, for example, the phase-out begins at

---

<sup>37</sup> Exemptions are of value, however, only to the extent they offset what otherwise would be positive taxable income. For some taxpayers, this taxable income limitation serves as a de facto ceiling on the number of dependency exemptions. In addition, exemptions are not allowed for purposes of the alternative minimum tax. IRC § 56(b)(1)(E).

<sup>38</sup> See S. Rep. 99-313, at 31-33, reprinted in 1986-3 C.B. (vol. 3) 1, 31-33 (indicating that one goal of the Tax Reform Act of 1986 was to prevent the imposition of the income tax on families at or below the poverty level). Since the 1986 legislation, the dependency exemption amount has closely tracked the increase in the HHS poverty threshold caused by an additional family member. For 2004, for example, the \$3,100 exemption amount is within \$80 of the \$3,180 amount in the HHS poverty guidelines. Dep't of Health and Human Services, Annual Update of the HHS Poverty Guidelines, pt. V, 69 Fed. Reg. 7335 (Feb. 13, 2004).

<sup>39</sup> The exemption may be of value, however, to taxpayers whose *tax liability* (as contrasted with *taxable income*) would have been zero or negative even in the absence of the exemption. Suppose, for example, that in the absence of the exemption a taxpayer with one child would have had \$500 of tax liability under IRC § 1 (10% of \$5,000 taxable income), would have been entitled to an EITC of \$2,500, and thus would have received a \$2,000 check from the government. Although there would have been no net-of-EITC tax liability even without the exemption, this taxpayer will benefit from the exemption. A \$3,000 exemption would reduce the taxpayer's pre-EITC tax liability to \$200 (10% of \$2,000 taxable income), and the taxpayer then would be entitled to a \$2,300 check from the government.

<sup>40</sup> See Zelenak, *Children*, note 2, at 361-72 (discussing the history and implications of the clear income concept).



\$214,050 AGI, and is completed at \$336,550.<sup>41</sup> For taxpayers with AGIs above the level at which the phase-out is completed, family size has no effect on tax liability. Congress recently decided to reconvert to the clear income theory, but is delaying the ceremony. The phase-out is scheduled to be reduced by one-third in 2006, by another one-third in 2008, and to be eliminated in 2010.<sup>42</sup>

### III. THE EITC AS A FAMILY-SIZE ADJUSTMENT TO THE MINIMUM WAGE

#### A. *The Basic Framework*

To those who care for our sick, who tend our children, who do our most difficult and tiring jobs, the new direction I propose will make this solemn, simple commitment: By expanding the refundable earned income tax credit, we will make history. We will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty.<sup>43</sup>

It seems a matter of simple justice. No family should have to live in poverty when the head of the family is employed full-time.<sup>44</sup> The question is how best to achieve this goal. Suppose, for the sake of illustration, that the official poverty level for one adult, living alone, is \$10,000, and that the official poverty level increases by \$3,000 for each child added to the household. One possibility would be a minimum wage tied to a worker's family responsibilities. Assuming 2,000 hours (40 hours per week for 50 weeks) constitutes full-time employment for a year, this means the minimum wage for a worker with no family

---

<sup>41</sup> Rev. Proc. 2003-85, note 22, § 3.16(2), at 1188-89 (inflation adjustment for 2004). For heads of households, the phase-out begins at \$178,350 and is completed at \$300,850. For other unmarried taxpayers, the phase-out begins at \$142,700 and is completed at \$265,200. The phase-out originated (in a form somewhat different from the current version) with the Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 101 Stat. 2085, 2097-98.

<sup>42</sup> IRC § 151(d)(3)(E), (F); Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, § 102, 115 Stat. 38, 44. The complete repeal of the phase-out is effective for only one year, however. As with all the provisions of the 2001 Act, the repeal of the phase-out is subject to sunset at the end of 2010. *Id.* § 901, 115 Stat. at 150.

<sup>43</sup> Clinton's Address to Joint Session of Congress (Feb. 17, 1993), 93 TNT 40-29, Feb. 19, 1993, available in LEXIS, Tax Analysts File (President Clinton's 1993 State of the Union Address).

<sup>44</sup> See Richard Kazis, Opportunity and Advancement for Low-Wage Workers: New Challenges, New Solutions, in *Low Wage Workers in the New Economy* 1, 4 (Richard Kazis & Marc S. Miller eds., 2001) (reporting results of a national survey, that "[m]ore than 90 percent of Americans believe that those who 'work hard and play by the rules' should be able to support their families through their work").

responsibilities should be \$5 per hour.<sup>45</sup> The minimum wage for a single parent with one child would be \$6.50 per hour,<sup>46</sup> the minimum wage for a single parent with two children would be \$8 per hour,<sup>47</sup> and so on. The problems with this approach are obvious. Faced with a choice between employing higher-cost parents or lower-cost workers without family responsibilities, employers would not hire parents for low-wage work. Some parents would be unemployed as a result, while others would claim to have no family responsibilities in order to be hired at \$5 per hour.

Another possibility would be to have only one minimum wage, but to set it at, say, \$8 per hour—high enough for a parent with two dependent children to reach the level of subsistence. This avoids giving employers an incentive not to hire workers with family responsibilities, but only at the cost of depressing employment of low-wage workers generally. It also confers a windfall of sorts on the childless low-wage worker whose wage rises from \$5 to \$8, and it leaves the low-wage worker with three or more children below the poverty level.<sup>48</sup>

A more attractive solution is to leave the minimum wage at \$5 per hour—enough to support a childless worker at a level of basic decency—and for the government to use a refundable tax credit to make up the difference between the resulting low wage and the poverty level for workers with family responsibilities. Assuming a minimum wage of \$5 per hour and the official poverty levels described above, this approach could be implemented by an EITC equal to the product of (1) the full-time minimum wage worker's \$10,000 earned income, (2) the number of children supported by the worker, and (3) 30%. Table 1 summarizes the results of this credit for minimum wage workers with different family responsibilities. No family headed by a full-time worker is left below the poverty level, employers are not discouraged from hiring workers with children or from hiring low-wage workers generally, and no windfall is conferred on low wage workers without children.

---

<sup>45</sup>  $\$5 \times 2,000 \text{ hours} = \$10,000$ . The actual hourly minimum wage is \$5.15. 29 U.S.C. § 206(a)(1) (1994 & Supp. V 1999).

<sup>46</sup>  $\$6.50 \times 2,000 \text{ hours} = \$13,000$ .

<sup>47</sup>  $\$8 \times 2,000 \text{ hours} = \$16,000$ .

<sup>48</sup> Edmund S. Phelps has suggested a variation on this theme. Phelps proposes a government subsidy to employers for hiring low-wage workers, which would pass through to the workers as increased wages. Edmund S. Phelps, *Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise* 115 (1997). For example, if an employer were willing to pay a worker \$5 per hour, the subsidy would be \$2.29 per hour and the worker would take home \$7.29 per hour. *Id.* at 113-14. Phelps' approach avoids the employment-depressing effect of a minimum wage mandate imposed on employers. It is not sensitive, however, to differences in family responsibilities among low-wage workers.

TABLE 1

<i>Number of Dependent Children</i>	<i>Official Poverty Level</i>	<i>Precredit Wages</i>	<i>Earned Income Tax Credit</i>	<i>After-Credit Wages</i>
zero	\$10,000	\$10,000	\$0	\$10,000
one	13,000	10,000	3,000	13,000
two	16,000	10,000	6,000	16,000
three	19,000	10,000	9,000	19,000

Despite President Clinton's recognition of the EITC's potential to lift working families with children out of poverty, the design of the current EITC is not wholly consistent with this anti-poverty goal.<sup>49</sup> For a worker with one qualifying child, the credit amount is 34% of the first \$7,660 of earned income, producing a maximum credit of \$2,640. For a worker with two (or more) qualifying children, the credit amount is 40% of the first \$10,750 of earned income, producing a maximum credit of \$4,300.<sup>50</sup> Relative to the official poverty guidelines,<sup>51</sup> which increase by \$3,180 for each additional child in a family, the maximum credit of \$2,640 credit for the first child is modestly too low, and the maximum additional credit of \$1,660 for the second child is decidedly too low.<sup>52</sup> The difficulty, however, is not solely with the too-low dollar amounts produced by the credit formula; the structure of the formula is also incorrect. Having two children rather than one should make no difference in the amount of earned income eligible for the credit, but should double the credit percentage applied to the earned income. Current law gets it wrong on both counts. The presence of a second child increases the amount of credit-eligible wages,

<sup>49</sup> There is a historical explanation for why the original 1975 version of the EITC was not conceived or designed as a family-size adjustment to the minimum wage. During the 1970's, the full-year, full-time minimum wage was sufficient to keep a family of three above the official poverty level. David T. Ellwood, *Poor Support: Poverty in the American Family* 110 (1988). Thus, a credit would have been needed as a minimum wage supplement, in the case of a single parent, only if the parent had three or more dependent children. By 1986, however, the annual minimum wage was 20% below the three-person poverty level. *Id.*

<sup>50</sup> Rev. Proc. 2003-85, note 22, at § 3.06.

<sup>51</sup> Dep't of Health and Human Services, note 38.

<sup>52</sup> If there were significant economies of scale with multiple children, the credit might reasonably be smaller for the second child than for the first child. It seems likely, however, that any such economies of scale, at the level of subsistence, are small or nonexistent. See Zelenak, *Children*, note 2, at 382-83 (reviewing studies suggesting only small economies of scale). The official HHS poverty levels assume there are no such economies of scale, as do the rules in IRC § 151 for determining the amount of dependency exemptions. See S. Rep. No. 99-313, note 38, at 31-33, reprinted in 1986-3 C.B. (vol. 3) at 31-33 (indicating that the dependency exemptions, along with the standard deduction, are intended to shelter subsistence-level income from tax). There is no evidence that the subsistence cost of a second child is less than two-thirds (\$2,640/\$4,300) the subsistence cost of a first child.

on which the second child should have no effect; and the second child increases the credit percentage only slightly, instead of doubling it. In fact, the increase in credit-eligible wages due to the second child is greater (in percentage terms) than the increase in the credit rate due to the second child.

Under current law, the presence of additional children beyond the first two has no effect on the amount of the credit.<sup>53</sup> This might be the result of a failure to understand how an EITC intended as a family size adjustment to the minimum wage should operate, or it might represent a conscious policy decision. A two-child ceiling for purposes of the EITC calculation might be intended to avoid giving low-wage workers an incentive to have more children than they can support without the credit subsidy.<sup>54</sup> If that is the rationale, it is not terribly persuasive. An additional credit generated by an additional child would merely cover the subsistence needs of the child, so the fertility of low-wage workers should not increase significantly in response to a credit for third and higher-order children.<sup>55</sup> Any minor fertility effect of an uncapped credit seems to be more than justified by the ability of an uncapped credit to lift children in larger families out of poverty. Of course, a cap on the number of credit-generating children also could be supported on nonconsequentialist grounds. That is, one might believe that the EITC rules have no significant fertility effects, yet still want to send a message to low-wage parents that they should not have more than two (or three, or whatever number) children until they can support a large family without government assistance.

Although the current version of the EITC can be understood, in part, as a family-size adjustment to the minimum wage, Congress also has in mind another purpose for the EITC—offsetting a portion of the burden of the payroll tax for low-wage workers.<sup>56</sup> This appears to be

---

<sup>53</sup> In 1999, 2,976,000 EITC recipients had more than two qualifying children. Making Work Pay, note 6, at 4 tbl.1.2. Credit recipients with more than two qualifying children constituted 18.4% of all EITC recipients, and 24.1% of all EITC recipients with children. *Id.*

<sup>54</sup> The legislative history of the EITC provides no explanation for the failure to provide an additional credit for families with more than two children. For further discussion of this issue, see Zelenak, *Children*, note 2, at 401-02. For a detailed proposal to provide increased EITC benefits to larger families, see Robert Greenstein, *Should EITC Benefits Be Enlarged for Families With Three or More Children?* (2000), available at [www.cbpp.org/3-14-00tax.pdf](http://www.cbpp.org/3-14-00tax.pdf). In 1990 the House passed a version of the EITC with a larger credit for families with three or more children, but it never became law. H.R. 3, § 213, 101st Cong. (1990). The Wisconsin state income tax includes an EITC under which three qualifying children increase the amount of the credit. Wis. Stat. § 71.07(9e)(af) (2002).

<sup>55</sup> See Zelenak, *Children*, note 2, at 399-00 (reviewing the literature on fertility effects of tax allowances for dependent children, and concluding that such effects appear to be small or nonexistent).

<sup>56</sup> H.R. Rep. No. 94-19, note 10, at 10, reprinted in 1975-1 C.B. at 573-74.

the sole purpose of the no-child EITC, which obviously does not serve as an allowance for family responsibilities, and the rate of which (7.65%) mirrors the rate of the payroll tax. It also may be one of the purposes of the one-child and two-child versions of the credit, although only a small portion of a 34% credit (one child) or a 40% credit (two children) can be explained as offsetting a 7.65% tax.<sup>57</sup> The version of the EITC proposed in this Article is intended to serve only as a family-size adjustment to the minimum wage. Congress might decide both to enact the version of the EITC proposed here, and to provide payroll tax relief for low-wage workers. Although it would be possible to combine a minimum wage adjustment and payroll relief into a single credit, greater clarity of purpose could be obtained by addressing payroll tax relief through a separate provision—either a credit intended solely as a payroll tax offset or a payroll tax exemption.<sup>58</sup>

### *B. A Different View of EITC Purpose and Design*

Jane Gravelle has offered a different explanation of the purpose of the EITC, from which follows a very different credit structure.<sup>59</sup> According to Gravelle, the income tax rate structure—both positive tax rates and the negative tax rates produced by the EITC—should be designed so that families with equal pretax standards of living also have equal after-tax standards of living.<sup>60</sup> To understand Gravelle's analysis of EITC design, it may be helpful to start in the more familiar context of positive tax rates. Imagine three households. In the first, adult *A* lives alone. In the second adult *B* lives with one child, and in the third adult *C* lives with two children. Suppose that (1) living together produces no economies of scale, and (2) a child achieves the

---

<sup>57</sup> To the extent the one-child and two-child EITCs are intended as payroll tax offsets, rather than as family-size adjustments to the minimum wage, they are that much less adequate as minimum wage adjustments.

<sup>58</sup> This credit or exemption also might be sensitive to family size. For example, the credit or exemption might be designed to eliminate the burden of the payroll tax on subsistence wages, with subsistence defined according to the worker's family responsibilities.

For an earlier proposal to replace the EITC with a child tax benefit and a payroll tax exemption, see George K. Yin & Jonathan Barry Forman, Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor, 59 Tax Notes 951 (May 17, 1993).

<sup>59</sup> Jane G. Gravelle, Federal Income Tax Treatment of the Family (Cong. Research Service 1991), reprinted in CRS Report Analyses Differential Tax Treatment of Families (Sept. 25, 1991), 91 TNT 202-28, Sept. 30, 1991, available in LEXIS, Tax Analysts File.

<sup>60</sup> *Id.* at 10. It is not self-evident to everyone that fairness in taxation requires after-tax maintenance of pretax equality of standard of living. See, e.g., Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (2002) (book-length argument that pretax income is a myth, and therefore the fairness of tax systems cannot be determined by reference to pre-tax income).

same standard of living from consuming  $(\$X)(0.3)$  as an adult achieves by consuming  $\$X$ . This produces a standard-of-living equivalency scale for the three households of 1:1.3:1.6. In other words, the three households will have equivalent standards of living as long as their consumptions are in the ratio of 1:1.3:1.6. Suppose the pretax income in the *A* household is \$50,000, in the *B* household is \$65,000, and in the *C* household is \$80,000. These incomes fit the equivalency ratio, so all three households would have the same standard of living in the absence of taxation. If all three households are to be subject to an income tax with progressive marginal tax rates, and all three households are to have equal after-tax standards of living, how should the tax rate structure adjust for family size? The first step is to construct a tax rate schedule applicable to *A*. Suppose the chosen structure taxes *A*'s first \$30,000 of income at 10%, and all additional income at 30%, thus producing a tax liability of \$9,000 and after-tax income of \$41,000. The pretax standard of living equivalency will be maintained if the width of the 10% bracket is increased for larger households, in accordance with the equivalency scale.<sup>61</sup> Thus, *B* should pay tax at the rate of 10% on the first \$39,000 ( $\$30,000 \times 1.3$ ) of income, and at the rate of 30% on the remaining income. Similarly, *C*'s 10% bracket should cover the first \$48,000 ( $\$30,000 \times 1.6$ ) of income. Table 2 summarizes the results of this approach, and demonstrates that it produces equivalent after-tax standards of living. The after-tax incomes of \$41,000, \$53,300, and \$65,600 are in the pre-tax ratios of 1:1.3:1.6. Also notice that each household pays tax at the same average rate (18%).

TABLE 2

<i>Taxpayer</i>	<i>Pretax Income</i>	<i>Width of 10% Bracket</i>	<i>Tax Liability</i>	<i>Average Tax Rate</i>	<i>After-Tax Income</i>
<i>A</i> (no children)	\$50,000	\$30,000	\$ 9,000	18%	\$41,000
<i>B</i> (one child)	65,000	39,000	11,700	18%	53,300
<i>C</i> (two children)	80,000	48,000	14,400	18%	65,600

Now suppose Congress has decided there should be a wage subsidy—a 20% negative tax rate in the form of an EITC—at the bottom of the tax rate schedule. Using the same equivalency scale assumed above, equal pretax standards of living would be achieved by childless *D* with \$12,000 of income, by one-child *E* with income of \$15,600, and

<sup>61</sup> If there were additional tax rate brackets below the top bracket, their width also should be increased in accordance with the equivalency scale.

by two-children *F* with income of \$19,200. Assuming the tax rate schedule applicable to *D* is -20% on the first \$10,000 of income and zero on the remainder, then the appropriate adjustments under the Gravelle approach are to extend *E*'s negative tax bracket to cover the first \$13,000 of earned income, and to extend *F*'s to cover the first \$16,000. The results are summarized in Table 3. The after-tax (that is, after-credit) incomes are in the ratio of 1:1.3:1.6, and the average tax rate is the same (-16.7%) for all three households.

TABLE 3

<i>Taxpayer</i>	<i>Pretax Income</i>	<i>Width of -20% Bracket</i>	<i>Tax Liability (Credit)</i>	<i>Average Tax Rate</i>	<i>After-Tax Income</i>
<i>D</i> (no children)	\$12,000	\$10,000	(\$2,000)	-16.7%	\$14,000
<i>E</i> (one child)	15,600	13,000	( 2,600)	-16.7%	18,200
<i>F</i> (two children)	19,200	16,000	( 3,200)	-16.7%	22,400

In sharp contrast with the model proposed in this Article, in a Gravelle-type EITC the number of children would have no effect on the credit percentage, but would increase the amount of income eligible for the credit. The Gravelle method is indeed the proper way to design an EITC that maintains precredit standard of living equivalencies. The question is whether maintaining precredit equivalencies is an appropriate goal of an EITC, or whether an EITC should be designed to lift working families with children out of poverty. In thinking about that question, three points are worth noting.

*First*, unlike the model proposed above, which explains the EITC as a family-size adjustment to the minimum wage, the Gravelle model does not explain why there should be an EITC at all, nor does it provide any answer to the question of how generous the EITC should be. It serves only one limited function; once one settles on an EITC design for a household of a particular size, it tells how to adjust the EITC design for families of different sizes.

*Second*, and again unlike the model proposed above, the Gravelle model implies that if there is to be an EITC at all, the credit should be available to childless workers as well as to workers with family responsibilities. In fact, childless workers would even be entitled to the same credit percentage (albeit applicable over a smaller income range) as workers with children. The effect would be to raise some childless minimum-wage workers *above* the poverty level, rather than merely *to* the poverty level.

*Third*, unless a Gravelle-type credit was designed to cover only a very small income range, workers with larger families would be able

to receive the maximum credit for their family size only by earning significantly more than the full-time minimum wage. As a result, applying the credit design reflected in Table 3 to a worker with two children and \$10,000 of earned income (\$5 per hour for 2,000 hours) would produce a credit of only \$2,000, leaving the family well below the poverty level. Thus, at the same time the credit lifts the three families in Table 3 (all with above-poverty *precredit* income) higher above the poverty level, it leaves the family of the minimum wage two-child worker in poverty. In particular, *F* (two children and \$19,200 of *precredit* income) receives a \$3,200 credit, while *F*'s minimum wage counterpart (two children and \$10,000 of *precredit* income) receives a credit of only \$2,000. From an anti-poverty perspective the result is perverse, and the result is not easily defended on work incentive grounds (because the full-time minimum wage worker denied a larger credit is working as hard as she can).

In short, the Gravelle approach is the technically correct way to achieve a particular goal—the maintenance, post-credit, of *precredit* standard of living equivalencies. In anti-poverty terms, however, the goal is singularly beside the point.

### C. *The Credit in the Broader Context of Food Stamps and the Social Security Tax*

The preceding explanation of how the EITC could function as a family size adjustment to the minimum wage omitted, for the sake of clarity of exposition, consideration of how the existence of other tax and transfer programs affecting low-wage workers might influence the design of the credit. This Section expands the analysis to consider the interplay between the EITC, the Social Security payroll tax, and food stamp benefits.<sup>62</sup> Taking the payroll tax and food stamps into account in the design of the EITC, the credit might be modified so that the sum of a full-time minimum wage worker's wages, EITC, and food stamp benefits, reduced by the worker's payroll tax liability, equaled

---

<sup>62</sup> Social Security and food stamps are the only two relevant programs that are uniform across the nation. (Apart from the EITC, the federal income tax is not relevant because the combination of the standard deduction and personal exemptions will prevent minimum wage working parents from having any pre-EITC federal income tax liability.) State income and sales taxes are not considered here because of the great variation in these taxes among the states. Similarly, each state selects its own benefit schedules for cash grants under Temporary Assistance for Needy Families (TANF). For detailed information on maximum TANF cash grants and phase-out rules for all the states, see Office of Family Assistance, Temporary Assistance for Needy Families (TANF) Fifth Annual Report to Congress XII-319 to XII-358 (2003), available at <http://www.acf.hhs.gov/programs/afa/annualreport5>. In most states, a single parent working full time all year at the minimum wage would have income too high to qualify for any TANF cash grant. *Id.* at XII-322 to XII-323 tbl.12:2 (maximum benefit levels), XII-328 to XII-330 tbl.12:5 (phase-out rules).



the official poverty level for the worker's family. In other words, the EITC might be made more generous to take into account the payroll tax, and less generous in response to food stamps.

The employee's share of the payroll tax equals a flat 7.65% of wages.<sup>63</sup> The food stamp benefit rules are more complicated. The maximum allotment level increases with the number of people in a household. In 2004 an eligible three-person household with no income would be entitled to a monthly food stamp allotment of \$371, or \$4,452 for an entire year.<sup>64</sup> For eligible households with income, the allotment is reduced by 30% of net income.<sup>65</sup> In general, net income equals gross income, reduced by an earned income deduction equal to 20% of earned income, and by a standard deduction of \$134 per month in 2004 (\$1,608 on an annual basis).<sup>66</sup> After the standard deduction has been exceeded, the effect of these rules is to reduce the food stamp allotment by 24% of wages (because 80% of wages go into net income, and the reduction is 30% of net income).<sup>67</sup>

If a single parent with two children earned \$10,300 by working full time for an entire year at the minimum wage (2,000 hours at \$5.15 per hour), the family's food stamp allotment for the entire year would be \$2,462.<sup>68</sup> This parent would be entitled to a two-child EITC of \$4,120 (40% of \$10,300), and would pay Social Security tax of \$788 (7.65% of \$10,300). Adding the wages, the food stamps, and the EITC, and subtracting the payroll tax, the parent would have total resources (cash and food stamps) of \$16,094. This is slightly higher than the official 2004 poverty threshold for a family of three, which is \$15,670.<sup>69</sup> Thus,

---

<sup>63</sup> This is the sum of the 6.2% OASDI tax imposed by IRC § 3101(a), and the 1.45% Medicare tax imposed by IRC § 3101(b). There is no need to adjust the EITC on account of the corresponding taxes imposed on employers by IRC § 3111, since an employee's stated wages do not include the employer's tax.

<sup>64</sup> The governing provision is 7 USC § 2017(a). The inflation adjustments for 2004 are set forth in Food and Nutrition Service, FY 2004 Allotments and Deduction Information, available at [www.fns.usda.gov/fsp/government/cola.htm](http://www.fns.usda.gov/fsp/government/cola.htm).

<sup>65</sup> 7 USC § 2014(d), § 2017(a).

<sup>66</sup> 7 USC § 2014(e)(1), (2). For the 2004 inflation-adjusted standard deduction, see Food and Nutrition Service, note 64.

<sup>67</sup> Considering food stamps and the EITC together, and viewing food stamps as equivalent to cash, the two programs can be understood as the equivalent of a universal cash grant or demogrant (equal to the food stamp allotment for a family with no income), combined with a wage subsidy equal to 10% of wages in the case of a one-child family (10% is the net of the 34% phase-in rate for the EITC and the 24% phase-out rate for food stamps), or 16% of wages in the case of a two-child family (the net of the 40% EITC rate and the 24% food stamp rate).

<sup>68</sup> With no income for the entire year, the allotment would be \$4,452. The worker's net income for the year is \$6,632 (that is, \$10,300, reduced by an earned income allowance of \$2,060 and by a standard deduction of \$1,608). The reduction in the allotment is \$1,990 (that is, 30% of \$6,632), leaving an allotment of \$2,462.

<sup>69</sup> Dep't of Health and Human Services, note 38.

the combination of the EITC and food stamps, under current law, is sufficient to lift this family out of poverty. The combination of food stamps and the credit is also sufficient to raise a full-time minimum wage worker with one child slightly above the poverty level.<sup>70</sup> As one might expect, however, the failure of the EITC to recognize the existence of more than two children means that the combination of food stamps and the EITC is not sufficient to lift minimum wage workers with more than two children out of poverty. A parent with three children, who works 2,000 hours per year at the minimum wage, will find her family living more than \$1,500 below the poverty level,<sup>71</sup> and the situation will worsen as the number of children increases.

Even for minimum wage parents with fewer than three children, the combination of food stamps and the EITC will lift their families out of poverty only if their families participate in the food stamp program. Among families with children and monthly income between 50 and 100% of the federal poverty level, only about one in four participates in the food stamp program.<sup>72</sup> In sharp contrast, more than four out of five eligible families with children participate in the EITC.<sup>73</sup> The tremendous difference in participation rates between the two programs is due to the fact that it is much more burdensome to participate in a

---

<sup>70</sup> With \$10,300 wages, the payroll tax is again \$788. The one-child EITC is \$2,604 (34% of \$7,660, the maximum amount of credit-generating earned income). The food stamp allotment is \$1,118. (The annual food stamp allotment for a two-person household with no income is \$3,108 (\$259 per month). Food and Nutrition Service, note 64. This allotment is reduced by \$1,990 (30% of net income of \$6,632), producing the allotment of \$1,118.) Adding together the wages, the EITC, and the food stamps, and subtracting the payroll tax, produces total resources of \$13,234. The 2004 poverty threshold for a family of two is \$12,490. Dep't of Health and Human Services, note 38.

<sup>71</sup> Wages are \$10,300, the payroll tax is \$788, the two-child EITC is \$4,120, and the food stamp allotment is \$3,662. (The annual food stamp allotment for a four-person household is \$5,652 (\$471 per month). Food and Nutrition Service, note 64. This allotment is reduced by \$1,990 (30% of net income of \$6,632), producing the allotment of \$3,662.) Adding together wages, EITC, and food stamps, and subtracting the payroll tax, total resources are \$17,294. The 2004 poverty threshold for a family of four is \$18,850. Dep't of Health and Human Services, note 38.

<sup>72</sup> Sheila R. Zedlewski, *Recent Trends in Food Stamp Participation: Have New Policies Made a Difference?* (Urban Inst. Policy Brief, 2004), available at <http://www.urban.org/urlprint.cfm?ID=8867>. Zedlewski found that 26.5% of families with children and monthly income between 50 and 100% of the poverty level participated in the food stamp program. *Id.* at 4 tbl.2. Among families with no welfare experience (71% of all families in the monthly income range), the food stamp participation rate was only 15.9%. *Id.* These figures are for 2002, the most recent year studied by Zedlewski.

<sup>73</sup> According to the General Accounting Office, the participation rate is 96% among eligible families with one child, 93% among eligible families with two children, and 62.5% among eligible families with three or more children. U.S. General Accounting Office, *Earned Income Tax Credit Eligibility and Participation* 2 tbl.1 (GAO-02-290R, 2001). The weighted average of the three participation rates is approximately 86% (author's calculation).

program administered through the welfare bureaucracy than in a program administered through the tax system.<sup>74</sup>

Given the extremely low food stamp participation rate in the relevant population, it would be a mistake to design the EITC on the assumption that minimum wage workers with children are also receiving food stamps. While it would be theoretically possible to use a combination of food stamps and the EITC to lift minimum wage families out of poverty, under current conditions this possibility is illusory for the substantial majority of such families. Unless the food stamp nonparticipation problem can be solved, it would seem appropriate to design the EITC in the manner described in the preceding discussion—that is, as if the food stamp program did not exist.

#### *D. Some Credit Design Details*

##### *1. Setting the Credit Amount for Those Earning Less Than the Full-Time Annual Minimum Wage: The Phase-in Problem*

###### *i. Less Than Full-Time, Full-Year Workers Generally*

The preceding Subsection argues for a particular EITC design for those earning an amount equal to the full-time, full-year minimum wage. This Subsection considers how the EITC should be calculated for a minimum wage worker whose annual wages are less than that amount.

The federal government could guarantee a subsistence-level income to every family, even if no one in the family is employed. For example, if the poverty level for a one-adult, two-children family is \$16,000, the government could provide a \$16,000 cash grant to a three-person family with no earned income. The grant would then be phased out (perhaps on a dollar-for-dollar basis, or perhaps more slowly) as earned income rose above zero. As recounted earlier in this Article, however, the United States has rejected this guaranteed minimum income approach—partly because of a moralistic desire to limit grants to the deserving poor, and partly because of concern about the work disincentive effects of such a system.<sup>75</sup> The income effect of a large cash grant discourages work effort, and the substitution effect of the phaseout of the grant provides additional discouragement. The EITC also features a work-discouraging income effect. Because the amount of the EITC is positively associated with the amount of earned in-

---

<sup>74</sup> For a good summary of the burdens imposed on working families participating in the food stamp program, see Janet Holtzblatt, *Choosing Between Refundable Tax Credits and Spending Programs*, Proceedings of the 93rd Ann. Conf. on Tax'n 116, 119 (2001).

<sup>75</sup> See text accompanying notes 3-10.

come, however, the work-promoting substitution effect counteracts the income effect.<sup>76</sup>

In keeping with current political realities, this Article assumes that the basic choice between a guaranteed minimum income and an EITC already has been made in favor of an EITC. Thus, those with no earned income are to receive no subsidy. The question remains, however, how the credit should be phased in as earned income increases from zero to the full-time annual minimum wage.

Take the example of a single parent with two children, who works for 1,200 hours during the year at the minimum wage (\$5 per hour), earning a total of \$6,000. How large a credit should she receive? One possibility, reflected (in a general way) in the phase-in design of the current two-children EITC, would be to award her a credit equal to 60% ( $30\% \times 2$ ) of the lesser of \$10,000 or her actual earned income; thus, her credit would be \$3,600. Compare this with the \$6,000 credit received by another minimum wage parent with two children, who works full-time for the entire year and earns \$10,000. In distributional terms, the smaller credit to the needier family is perverse. Is that result justified, however, by the work incentive effect created by a phasing-in of the credit? In other words, is the smaller credit to the part-time minimum wage worker appropriate as a means of encouraging part-time workers to become full-time workers?

To a large extent, the answer depends on the reasons why a minimum wage parent might work 1,200 hours instead of 2,000 hours. If the typical worker earning \$6,000 could choose to work more hours, then it may make sense to deny that worker \$2,400 of potential credit in order to provide an incentive to work an extra 800 hours and qualify for another \$2,400 of credit. On the other hand, if the typical worker earning \$6,000 is involuntarily limited to 1,200 hours per year—because of a scarcity of jobs, or because of illness of herself or of a dependent child—then denying \$1,200 of credit serves no incentive function and is (as always) distributionally perverse. In that case, the parent earning \$6,000 should be entitled to the full \$6,000 credit.<sup>77</sup>

---

<sup>76</sup> The substitution effect of the EITC encourages work during the phase-in range of the credit. During the phase-out range, however, the credit's substitution effect discourages work. For a detailed discussion of issues relating to the phaseout of the credit, see Section IV.

<sup>77</sup> Actually, the working parent earning \$6,000 should be entitled to *at least* the full \$6,000 credit. It would be possible to go a step further, and also use the credit as a form of unemployment insurance. Under that approach, a \$6,000 earner with two children would be entitled to a \$10,000 credit—in effect, \$4,000 as unemployment insurance and \$6,000 to reflect the subsistence needs of the children. Combining the actual earnings, the unemployment insurance, and the child credit would bring the family's resources up to the \$16,000 poverty level.

As a somewhat stylized example, suppose the best evidence is that parents who have no earned income (or very little earned income) typically have chosen not to work, but that minimum wage parents who work at least 1,200 hours typically want to work 2,000 hours but are unable to do so (for one or more of the reasons noted above). On those assumptions, the credit should be fully phased in at \$6,000—a result that could be reached by making the per child credit equal to 50% of the first \$6,000 of the parent's earned income. This analysis suggests that the credit phase-in rules might vary with the economic cycle. When jobs are plentiful, most underemployment might be voluntary, so the per child credit might be 30% of the first \$10,000 of earned income. But in a recession, when most underemployment might be involuntary, the credit might be 50% of the first \$6,000.<sup>78</sup>

Rather strangely, whether the current EITC is fully phased in for a worker earning less than the annual minimum wage depends on the number of qualifying children. A worker with two or more qualifying children must earn slightly more than the annual minimum wage to qualify for the maximum credit. The maximum credit is reached at earned income of \$10,750,<sup>79</sup> and the annual minimum wage is \$10,300 ( $\$5.15 \times 2,000$  hours). By contrast, a worker with one qualifying child reaches the maximum credit amount at less than 75% of the annual minimum wage. The one-child maximum credit amount is reached at earned income of \$7,660,<sup>80</sup> the amount earned by working 1,487 hours at the minimum wage.<sup>81</sup> Although completing the one-child phase-in below the annual minimum wage can be justified on the assumption that most underemployment of one-child credit claimants is involuntary, there is no obvious reason for making different assumptions with respect to involuntariness of underemployment based on the number of qualifying children.

The design of the United Kingdom's version of an earned income tax credit, the Working Families Tax Credit (WFTC), provides the maximum credit to workers employed less than full time.<sup>82</sup> Eligibility

---

<sup>78</sup> Another response to the problem of involuntary unemployment would be to treat unemployment compensation as earned income for purposes of the EITC, so that a parent in the phase-in range of the credit could receive additional credit equal to 34% or 40% of the unemployment compensation. Although unemployment compensation is included in gross income under current law, IRC § 85, it is not treated as earned income for purposes of the EITC. IRC § 32(c)(2)(A); Treas. Reg. § 1.32-2(c)(2).

<sup>79</sup> Rev. Proc. 2003-85, note 22, at § 3.06.

<sup>80</sup> Id.

<sup>81</sup>  $\$5.15 \times 1,487 = \$7,660$ . A worker with no qualifying children reaches the maximum credit amount at earned income of \$5,100, id., the amount earned by working 990 hours at the minimum wage ( $\$5.15 \times 990 = \$5,100$ ).

<sup>82</sup> The WFTC is described in Jeffrey B. Liebman, *The Optimal Design of the Earned Income Tax Credit*, in *Making Work Pay*, note 6, at 196, 210.

for the WFTC is based on hours worked per week, rather than on annual earnings. A low-wage worker employed less than 16 hours per week receives no credit, while a worker employed at least 16 hours per week is eligible for the maximum credit amount.<sup>83</sup> Assuming a \$5 hourly minimum wage and a 2,000 hour work year (40 hours per week for 50 weeks), the WFTC approach translates into an EITC of zero for a worker with annual income below \$4,000, and a maximum EITC (for example, \$3,000 per child) for a low-wage worker earning \$4,000 or more.

Jeffrey Liebman has noted one possible explanation for the phase-in of the EITC, in contrast with the cliff effect eligibility rule under the WFTC; in the case of a credit based on annual income, a phase-in is needed to “create a work incentive for workers who are entering the work force in the middle of the year.”<sup>84</sup> This concern for midyear entrants into the labor force explains why the EITC should not provide a credit of zero to a person earning below some specified threshold amount. It does not, however, explain why a person earning less than \$10,000 for the year should receive less than the maximum credit amount. A credit fully phased in at \$6,000 earned income, for example, would be consistent with the desire to provide a work incentive for midyear entrants.

Liebman used data from the 1999 Current Population Survey (CPS) to run a series of simulations to evaluate several different EITC designs.<sup>85</sup> Among other things, he examined the effects of four different rules for phasing in the credit, with all four sets of rules designed to produce the same maximum credit amount (the current-law maximum). The four variations were: (1) no credit allowed unless the worker had earned income equal to or greater than the maximum credit-generating amount (thus a worker would receive either no credit or the maximum credit); (2) the maximum credit amount reached via a 30% phase-in; (3) the maximum credit amount reached via a 34% phase-in for a worker with one child, and via a 40% phase-in for a worker with two children (that is, the phase-in rules of the current EITC); and (4) the maximum credit amount reached via a 60% phase-in rate.<sup>86</sup> Running simulations based on three different compensated wage elasticities, Liebman found that under all three elasticity assumptions, a phase-in rate of 30% “produce[d] lower costs for each dollar’s worth of utility gain than [did] either lower or higher phase-in rates.”<sup>87</sup> Liebman explains: “This occurs because as the

---

<sup>83</sup> Id. at 210 tbl.5.4.

<sup>84</sup> Id. at 210.

<sup>85</sup> Id.

<sup>86</sup> Id.

<sup>87</sup> Id. at 212.

phase-in rate rises from zero to 30 percent, significant numbers of welfare recipients are entering the labor force. As the rate rises above current law, however, very few additional participants enter, and the main impact is to induce higher-earning taxpayers to reduce their earnings.”<sup>88</sup>

Liebman’s model does not consider, however, the possibility of involuntary unemployment (or underemployment) as a major explanation for annual earnings below the full-time, full-year minimum wage. A more rapid phase-in might be indicated, in spite of Liebman’s results, if most workers who earn less than, say, \$10,000 per year are frustrated in their attempts to find additional hours of employment.

## ii. *Parents of Young Children*

If one assumes (1) that anyone working less than 2,000 hours per year has *chosen* not to work full time, and (2) that low-wage workers *should* work full time, then it makes sense not to award the maximum credit to anyone earning less than the full-time annual minimum wage (say, \$10,000). The preceding discussion considered the effect of rejecting the first assumption. The second assumption is also questionable. Society might decide that parents of young (below school age) children should have less than full-time employment. For example, society might decide that, given the need of young children for significant amounts of parental caregiving, parents of young children (or perhaps just *single* parents of young children) should not be expected to be employed more than 30 hours per week (1,500 hours per year). What would this imply for EITC design? At a minimum, this would mean that a parent of a young child should not be penalized for working 1,500 hours rather than 2,000 hours; the parent should be eligible for the maximum credit amount with earned income of only \$7,500 ( $\$5 \times 1,500$  hours). Thus, the per child credit for such a parent should be 40% of the first \$7,500 of earned income,<sup>89</sup> assuming the per child credit for other parents is 30% of the first \$10,000. More ambitiously, society might decide that the credit should be sufficient to raise the single parent and her young child to the poverty level, as long as the parent works at least 1,500 hours during the year. In other words, the credit might be designed to cover both the \$3,000 subsistence cost of the child and the \$2,500 forgone wages caused by the need for the parent to spend time with the child. The resulting credit formula, for a parent with one child, would be 73.3% of the first \$7,500 of earned

<sup>88</sup> Id.

<sup>89</sup>  $40\% \times \$7,500 = \$3,000$ .

income.<sup>90</sup> Each additional child would produce a credit of \$3,000, calculated as 40% of the first \$7,500 of earned income.

## 2. *The Effect of Higher-Wage Part-Time Workers on the Maximum Credit Amount and on Phase-in Design*

If the Service could observe taxpayers' wage rates, the maximum EITC amounts (and the phase-in schedules) could be designed to be wage-rate dependent. Start from an assumed baseline of a per child credit of \$3,000 (30% of the first \$10,000 of earned income) for a parent with an hourly wage rate of \$5. In that case, the appropriate EITC for a parent with a \$6 per hour wage rate would increase annual wages by \$1,000 (from \$12,000 to \$13,000) on account of the first child, by \$3,000 (from \$13,000 to \$16,000) on account of a second child, and by \$3,000 on account of each additional child. Assuming the phase-in is to produce the maximum credit amount only when the taxpayer has been employed full-time for the entire year (that is, 2,000 hours), the phase-in formula for the \$6 per hour worker would be 8.3% of the first \$12,000 of wages on account of the first child, and 25% of the first \$12,000 of wages on account of each additional child. For a parent with a \$7 hourly wage, there would be no credit for the first child; even without a credit the wages from full-time employment (\$14,000) exceed the family's poverty level (\$13,000). There would be, however, a \$2,000 credit on account of the second child (raising family income from \$14,000 to the \$16,000 poverty level), and a \$3,000 credit on account of each additional child.<sup>91</sup>

Compared with this treatment of workers with wage rates modestly above the minimum wage, the credit formula based on the minimum wage (a per child credit equal to 30% of the first \$10,000 of earned income) produces inappropriately large credits for a worker with an hourly wage of \$6 or \$7, who earns only \$10,000 for the year because of working less than 2,000 hours. Assuming the Service is incapable of observing workers' hourly wage rates, for the purpose of applying different maximum credit amounts and different phase-in schedules to

---

<sup>90</sup>  $73.3\% \times \$7,500 = \$5,500$ . Added to the \$7,500 precredit wages, the \$5,500 credit raises the family to its poverty level of \$13,000.

<sup>91</sup> These results would be reached by allowing a credit of 14.3% of the first \$14,000 of earned income on account of the second child, and a credit of 21.4% of the first \$14,000 of earned income for each additional child.



workers with different wage rates,<sup>92</sup> how should the EITC address this difficulty?<sup>93</sup>

There is no single correct solution, but two points are worth noting. First, to the extent the higher-wage earner's low annual wages are due to involuntary unemployment (due to unavailability of work, or to health problems of the worker or her family), there is no good reason to treat this worker any differently from the full-time minimum wage worker. In other words, there is no EITC design problem caused by the inability to distinguish between the involuntarily underemployed higher wage worker and the fully employed minimum wage worker.

Second, to the extent higher wage workers are voluntarily underemployed, the choice is between (1) an EITC design that is fair to fully employed minimum wage workers but overly generous to higher-wage part-time workers, or (2) an EITC design that is fair to higher-wage part-time workers but inadequate for full-time minimum wage workers. In making this choice, one would want empirical evidence about which approach would produce more mistakes. If, for example, working parents rarely earn less than \$6 per hour,<sup>94</sup> and if annual earnings of less than \$12,000 are almost always due to voluntary underemployment of above-minimum wage workers, then an EITC designed to be fair to \$6 per hour workers (but unfair to minimum wage workers) may be reasonable. In any event, there remains the value judgment as to which type of mistake is worse. Arguably, fairness to minimum wage workers and their families should be the paramount concern, to

---

<sup>92</sup> It is certainly possible to question the premise that the tax administrator cannot be expected to observe wage rates. The UK's WFTC, described in text accompanying notes 82-84, requires a determination of hours worked per week. If the tax administrator can observe hours worked and total earnings, the hourly wage rate can be derived. Of course, if the tax administrator is able to observe wage rates, the EITC-type approach (based on annual income) may be rejected in favor of a wage supplement. For example, for every hour worked at a \$5 wage rate by a parent with one child, the government might provide a wage subsidy of \$1.50. See Edgar K. Browning, Effects of the Earned Income Tax Credit on Income and Welfare, 48 Nat'l Tax J. 23, 42 (1995) (positing that in light of the "disadvantages of the EITC . . . perhaps it is time to reconsider the possibility" of a wage rate subsidy); Michael J. Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 Yale L.J. 261, 290-93 (2002) (proposing a replacement for the EITC, based on the assumption that the Service can determine weekly hours worked). Perhaps the biggest problem with wage rate supplements is that they give employers and employees an incentive to cheat—even while reporting the correct total amount of compensation—by understating the actual wage rate and correspondingly overstating the hours worked.

<sup>93</sup> Workers with wage rates modestly above the minimum wage also raise issues concerning the phase-out of the EITC. These issues are discussed in Section IV. The discussion here is limited to the effects on the maximum credit amount and on phase-in design of the Service's presumed inability to distinguish between a full-time minimum wage worker and a part-time higher wage worker with the same annual income.

<sup>94</sup> See Gregory Acs, Katherin Ross Phillips & Daniel McKenzie, Playing by the Rules, but Losing the Game: Americans in Low-Income Families, in Kazis & Miller, note 44, at 21, 30 (in 1996, the median hourly wage of primary earners in low-wage families was \$7.55).

be pursued even at the risk of undue generosity to a larger number of part-time higher-wage workers.<sup>95</sup>

Putting the two points together, there is a strong argument for designing the EITC to be fair to minimum wage working parents. Many higher-wage parents working fewer than 2,000 hours per year will have worked as many hours as reasonably could be expected of them, and leaving deserving minimum wage parents (and their children) below the poverty level seems a worse mistake than granting excessive benefits to voluntarily underemployed higher-wage parents (whose children are presumably deserving, even if the parents are not).

#### IV. IS A PHASE-OUT NECESSARY?

##### A. *The Conventional Wisdom and the Shaviro Critique*

The phase-out of the EITC operates as an increase in the marginal tax rate for taxpayers with incomes modestly above the poverty level. Considering just the EITC phase-out and the regular income tax rate schedule, a lower-wage worker with two children typically will face a marginal tax rate of over 30%.<sup>96</sup> Add in the Social Security wage tax and state income tax, and the overall marginal rate on income slightly above poverty can approach 50%.<sup>97</sup> The EITC phase-out produces a marginal tax rate “bubble” on income just above the poverty level; once the phase-out has reduced the EITC amount to zero, the phase-out ends and the taxpayer’s effective marginal tax rate drops. Nobody is happy about imposing such high marginal tax rates—high both in an absolute sense and relative to the rates imposed on higher-wage workers—on lower-wage workers. For workers who understand how the phase-out operates, there is a significant work disincentive effect; for workers who do not understand the phase-out, the resulting stealth tax is arguably unfair. Nevertheless, the phase-out and its high marginal rates usually are viewed as necessary evils. The conventional wisdom is that the EITC must be phased out as income rises above the poverty level in order to appropriately target the subsidy to the work-

---

<sup>95</sup> For an analysis of an analogous issue, in the context of a proposal for a formula-based income tax deduction to reflect basic costs of employment (such as commuting and work clothes), see Lawrence Zelenak, *The Income Tax and the Costs of Earning a Living*, 56 *Tax L. Rev.* 39, 62-66 (2002).

<sup>96</sup> This is the sum of the official income tax rate of 10%, IRC § 1(i), and the 21.06% EITC phaseout rate, IRC § 32(b)(1)(A).

<sup>97</sup> On the other hand, the phased-in refundability of the child tax credit operates as a 15% *negative* marginal tax rate over part of the income range to which the EITC phase-out applies. See IRC § 24(d). For a taxpayer subject to the lowest tax rate under § 1(i), the phase-out of the two-children EITC, and the phase-in of the child tax credit, the net marginal tax rate would be 16.06% (10% plus 21.06% minus 15%).

ing poor and near-poor.<sup>98</sup> In simplest terms, a phase-out is necessary in order to prevent Bill Gates from receiving an EITC.

Daniel Shaviro has offered a powerful critique of the conventional wisdom. According to Shaviro, the belief that a phase-out is necessary is based on a conceptual error: "The mistake here lies in considering the phase-out range a question of 'program cost,' rather than of establishing an overall rate structure in light of all tax and transfer programs that cause one's wages (or other income) to affect one's tax liability or transfer receipts."<sup>99</sup> According to the conventional wisdom, it is necessary that high-wage workers not be nominally entitled to the EITC, and the only way to eliminate their nominal entitlement is with the rate bubble effect of an explicit phase-out. Shaviro's insight is that the EITC can be taxed away, for higher wage workers, even without an explicit phase-out. Suppose, for example, all workers with two children are nominally entitled to a \$6,000 EITC, and are subject to a flat tax of 20% on all their taxable income.<sup>100</sup> There is no explicit phase-out and therefore no rate bubble, but the 20% tax would fully offset the benefit of the credit for a taxpayer with \$30,000 of taxable income. A taxpayer with two children and \$100,000 of taxable income will owe a net tax of \$14,000: \$20,000 tax less \$6,000 EITC. As long as we are satisfied that zero is the correct net tax liability for a worker earning \$30,000, and that \$14,000 is the correct net tax liability for a worker earning \$100,000, there is no reason to object to the fact that those workers—and, for that matter, Bill Gates—are nominally entitled to the EITC. And if a higher net tax liability for high-wage earners is desired, that can be achieved without an EITC phase-out simply by increasing the marginal tax rate on their last dollars of income. Shaviro concludes that "the income phaseouts of such social welfare programs as . . . the EITC are irrational—mainly because they create unduly high marginal rates in low-income brackets, although secondarily because they cause marginal rates to bounce up and down for no apparent reason."<sup>101</sup>

In its negative aspect, Shaviro's critique is compelling. The phase-out of the EITC is based on the assumption that it is inherently objectionable for a high-wage worker to be entitled to claim the EITC in

---

<sup>98</sup> See, e.g., Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 533, 551 (1995) ("In an income-tested transfer program such as the EITC, it is impossible simultaneously to provide generous benefits, to keep program costs low by paying benefits only to the poor, and to keep benefit reduction [that is, phaseout] rates low.").

<sup>99</sup> Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. Chi. L. Rev. 405, 463 (1997).

<sup>100</sup> A single marginal tax rate is used for simplicity of illustration, but the point of the example applies just as much in the case of a progressive marginal tax rate structure.

<sup>101</sup> Shaviro, note 99, at 409.

calculating his net tax liability, and that assumption is simply wrong. In its positive aspect, however, Shaviro's critique is considerably less persuasive. It may be appropriate to phase out the EITC, even though the usual justification for the phase-out does not survive scrutiny. This Article considers three possible justifications for a phase-out, beyond the justification so persuasively criticized by Shaviro: (1) that a marginal tax rate bubble immediately above the poverty level might be called for by optimal tax analysis; (2) that a phase-out may be appropriate if the official poverty level has overwhelming public policy significance; and (3) that a phase-down (but not a phase-out) is necessary to avoid unduly large differences in tax liabilities based on family size at middle- and upper-income levels. The first two of these justifications are not so easily dismissed as the justification critiqued by Shaviro, and the third justification is compelling.

### *B. Optimal Income Tax Analysis and a Marginal Tax Rate Bubble*

In a seminal article published in 1971, James Mirrlees invented the field of optimal income tax analysis.<sup>102</sup> The basic insight of optimal income tax analysis is that taxation for the purpose of redistribution has countervailing welfare-enhancing and welfare-decreasing effects. On the one hand, transferring a dollar from a rich person to a poor person is welfare-enhancing, because it increases the poor person's welfare more than it decreases the rich person's welfare. On the other hand, imposing the tax on the rich person decreases welfare to the extent of the efficiency loss caused by the disincentive effect of the tax. The analysis originated by Mirrlees, and further developed by him and others, provides sophisticated mathematical techniques for balancing the gain from redistribution against the efficiency cost of taxation. Most optimal tax analysis is based on simulations. Having made certain assumptions (about the distribution of wage rates in society, about labor supply elasticity, about the rate at which the marginal utility of income declines, and about societal "taste" for redistribution), an optimal tax analyst can produce a tax-and-transfer system that maximizes social welfare. The resulting tax-and-transfer system generally consists of a universal cash grant (a "demogrant") of some specified amount per person, and a marginal tax rate structure applied to income. A person whose cash grant exceeds the tax liability produced by the marginal tax rate structure receives a net transfer; a person whose cash grant is less than the tax liability makes a net payment.

---

<sup>102</sup> J.A. Mirrlees, An Exploration in the Theory of Optimum Income Taxation, 38 Rev. Econ. Stud. 175 (1971).

Labor economists distinguish between labor supply decisions made at the “intensive margin” and decisions made at the “extensive margin.” A decision to work a few hours more or a few hours less is made at the intensive margin; a decision to work full-time or not at all is made at the extensive margin.<sup>103</sup> The standard approach in the optimal tax literature has been to assume that an individual’s behavioral response to a tax-and-transfer system is along the intensive margin only. Under that assumption, it has been demonstrated that the optimal tax-and-transfer system should never feature negative marginal tax rates.<sup>104</sup> Redistribution should be accomplished solely through the demogrant, and all marginal tax rates should be zero or positive. Since an EITC is nothing more than a negative marginal tax rate applicable to the first dollars of earned income, standard optimal tax analysis concludes that an EITC is never indicated.<sup>105</sup> Since standard optimal tax analysis rejects the EITC, standard optimal tax analysis makes no attempt to determine whether an EITC should be subject to phase-out.

Recently, however, Emmanuel Saez has shown that the optimal tax structure may include an EITC-like negative marginal tax rate if labor supply decisions are made largely along the extensive margin—in other words, if most labor supply decisions are participation decisions.<sup>106</sup> To see the intuition underlying this result, start with the observation that the most welfare-enhancing redistribution is to the least-skilled (that is, lowest wage rate) workers. If redistribution is accomplished solely by means of a demogrant, the largest net transfers will be made to unemployed persons (who receive the full amount of the demogrant, without any offsetting tax liability). To the extent the unemployed include those not in the lowest wage rate group, this is not an ideal result. On the assumption that the labor supply decision is all or noth-

---

<sup>103</sup> James J. Heckman, *What Has Been Learned About Labor Supply in the Past Twenty Years?*, 83 *Am. Econ. Rev.* 116, 116 (1993).

<sup>104</sup> Matti Tuomala, *Optimal Income Tax and Redistribution* 92 (1990); Jesus Seade, *On the Sign of the Optimum Marginal Income Tax*, 49 *Rev. Econ. Stud.* 637, 642 (1982).

<sup>105</sup> Emmanuel Saez explains this result by imagining a tax structure with a negative tax rate (that is, an EITC), and showing how welfare would be increased by lessening or eliminating the negative tax rate:

If there is a negative marginal rate in some range . . . , then, by slightly increasing [that is, moving closer to zero] this rate, . . . the government reduces work incentives in that range . . . but because the marginal tax rate is negative in that range, people who . . . [respond by earning less] end up paying more taxes. Moreover, this small marginal tax rate increase allows the government to raise money from all taxpayers . . . [at higher income levels] which is also beneficial when the government values redistribution.

Emmanuel Saez, *Optimal Income Transfer Programs: Intensive Versus Extensive Labor Supply Responses*, 117 *Q.J. Econ.* 1039, 1053 (2002).

<sup>106</sup> *Id.* at 1055.

ing (for example, between no employment and full-time employment), the group of people earning the full-time annual minimum wage consists solely of lowest wage rate workers, and is thus a more attractive group for redistribution than the mixed wage rate group of the unemployed. By reducing the demogrant and creating an EITC, the targeting of transfer payments to lowest wage rate workers can be improved.<sup>107</sup> Saez acknowledges that actual labor supply responses occur at both the intensive and extensive margins,<sup>108</sup> but his review of the empirical literature suggests that many low-wage workers do make decisions at the extensive margin (that is, labor force participation decisions), especially the elderly, single mothers, and secondary earners in marriages.<sup>109</sup> Thus, it is plausible that an EITC would be part of the structure of an optimal tax-and-transfer system, under real world conditions.<sup>110</sup>

For purposes of this Article, the major significance of Saez's study is that it is now possible to consider whether optimal tax analysis supports the phase-out of an EITC, in those cases in which the optimal tax structure includes negative marginal tax rates. Saez reports the results of a number of simulations, based on different labor supply elasticity assumptions. When low-wage workers have high participation elasticity and zero labor supply elasticity at the intensive margin, the simulation calls for a \$5,400 demogrant, an average marginal tax rate of negative 23% (that is, an EITC) on the first \$6,000 of income, an average marginal tax rate of 71% in the \$6,000-to-\$15,000 income range, and an average marginal tax rate of 48% above \$30,000 income.<sup>111</sup> The 71% marginal tax rate bubble, in the income range just above the range of the negative marginal tax rate (the EITC), resembles the marginal tax rate bubble produced by the phase-out of the actual EITC.

In light of results from the standard (non-EITC) optimal tax literature, high marginal tax rates near the bottom of the income range are not surprising. In fact, in most optimal tax simulations—based on a wide range of assumptions—the highest marginal tax rates appear in the bottom decile of the societal wage distribution, with marginal tax rates steadily decreasing above that level.<sup>112</sup> Although there are no

---

<sup>107</sup> *Id.* at 1049-50.

<sup>108</sup> *Id.* at 1054.

<sup>109</sup> *Id.* at 1056.

<sup>110</sup> In Saez's "benchmark" simulation, however, using the labor supply elasticity assumptions that he believes most closely approximate reality, there is no negative marginal tax rate. *Id.* at 1063-64.

<sup>111</sup> *Id.* tbl.1, panel A. (Saez does not report the average marginal tax rate in the \$15,000-to-\$30,000 income range.)

<sup>112</sup> Tuomala, note 104, at 95-99.

EITCs in the results of these simulations, the high marginal tax rates applicable at low income levels might be interpreted as a phasing out of the demogrant.

In both the Saez case and the standard case, however, the interpretation of the high marginal tax rates as a phasing out of the EITC or the demogrant does not survive scrutiny. As a matter of arithmetic, the simulation results do not neatly mimic explicit phase-outs. That is, the simulations do not produce rate bubbles that end at precisely the point where the additional tax liability generated by the rate bubble equals the amount of the EITC or demogrant.<sup>113</sup> The rate bubbles of the simulations do not mimic phase-outs because explicitly phasing out transfer payments is simply not a concern of optimal tax analysis.<sup>114</sup>

Do the results of optimal tax simulations—particularly Saez' results—support the EITC phase-out? In his article, Shavero notes that a tax structure designed to produce particular distributional results conceivably could include high marginal tax rates on slightly-above-sub-

---

<sup>113</sup> Strictly speaking, an explicit phase-out need not involve an effective marginal tax rate bubble, if the phase-out is designed to mesh with the breakpoints in the regular (non-phase-out) marginal tax rate structure. For an example and a fuller explanation, see notes 380–39 and accompanying text.

<sup>114</sup> The explanation for the optimality of declining marginal tax rates has nothing to do with phasing out the demogrant:

It is easy to see how the utility gains from redistribution push the optimal tax in the direction of progressive marginal rates. But there is a powerful counter-vailing force, the influence of which is less obvious. High tax rates impose an efficiency cost only when they apply at the margin—that is, at the point where a taxpayer actually is choosing between paid work and leisure. When a high tax rate applies to a taxpayers' [sic] submarginal earnings, it raises revenue for utility-enhancing redistribution without substitution effect distortion. To that taxpayer, the high rate on submarginal income functions as a nondistorting lump sum tax.

From an efficiency standpoint, then, an attractive income range at which to apply a high marginal rate will be a range where there are many taxpayers for whom that range is submarginal, relative to the number of taxpayers within that range. Most of the revenue raised by a high tax rate in that range will come without any substitution effect distortion. Conversely, efficiency concerns suggest the tax rate should be low in any income range where the ratio of submarginal taxpayers to marginal taxpayers is low. Because the range is marginal for a high percentage of the taxpayers to whom it applies, a high rate tax at that range will impose a high efficiency cost per tax dollar collected. If the ratio of submarginal to marginal taxpayers declines as one moves up the income distribution, the efficiency cost of high marginal tax rates will be greater in the higher income ranges. Under the standard assumption in the optimal tax literature of a log-normal distribution of wage rates, that ratio does decline as income increases. Although the declining marginal utility of money pushes the optimal tax toward progressive marginal rates, the decreasing submarginality of rates at high income levels pushes strongly in the opposite direction.

Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 *Tax L. Rev.* 51, 54-55 (1999) (footnote omitted).

sistence income, without any intent to phase out the EITC as such.<sup>115</sup> He adds, however, that he “would be quite surprised to find that high marginal tax rates on the poor are optimal.”<sup>116</sup> As it happens, the results of the Saez simulations (and the analogous results of other optimal tax simulations not involving negative tax rates) are inconsistent with Shaviro’s intuition; high marginal tax rates on the poor—or at least on the near-poor—do seem to be optimal.

The strange result, then, is that the EITC phase-out may make good policy sense, for reasons completely different from the reason they were enacted. Contrary to the conventional wisdom motivating the phase-out, there is nothing wrong with Bill Gates being nominally entitled to the EITC. On the other hand, there appears to be a good reason, founded in optimal income tax analysis, for the effective marginal tax rate structure to be quite similar to that produced by the combination of the official § 1 marginal tax rates and the EITC phase-out—similar, perhaps, but certainly not identical. Shaviro correctly notes that “[t]he decision to end the temporarily high marginal rate precisely at the point where the effect of the EITC change on current year tax liability had been eliminated would be quite arbitrary.”<sup>117</sup> Moreover, nothing in optimal income tax analysis provides any justification for the way in which the size of a taxpayer’s phase-out-created rate bubble depends on the existence and number of dependent children.<sup>118</sup> Subject to these qualifications, however, it is remarkable that a phase-out enacted for mistaken reasons may accidentally produce a marginal tax rate structure defensible (in broad outline) on completely different grounds.

### *C. Justifying a Credit Phase-out if the Official Poverty Levels Are Overwhelmingly Significant*

Quite apart from the rate bubbles produced by many optimal tax simulations, the credit phase-out can be justified if one attaches sufficient significance to the official poverty levels. Suppose one believes (1) that rather than poverty being a matter of degree, there is a world of difference between the decent standard of living that can be obtained by income exactly at the poverty level, and the miserable existence that can be supported by income below (even slightly below) that level, (2) that redistribution is morally justified only for the purpose of relieving poverty, and (3) that poverty relief is justified only for the “deserving” (that is, working) poor. It would seem to follow

---

<sup>115</sup> Shaviro, note 99, at 465.

<sup>116</sup> *Id.* at 470.

<sup>117</sup> *Id.* at 465.

<sup>118</sup> IRC § 32(b)(1).



from that set of beliefs that the tax-and-transfer system should ensure that no family with a full-time wage earner has disposable income below the poverty level, but that there is no justification for further redistribution to raise any family even one dollar above the poverty level. Apart from concerns about the incentive effects of a confiscatory marginal tax rate, this would justify the most draconian of all phase-outs—a phaseout at the rate of 100% as a parent's earnings increased above the annual minimum wage. The table below illustrates the appropriate credit amounts, under this view, for wage earners with different low wage rates. All wage earners considered in the table are single parents, working full-time for the entire year, and supporting two children. The assumed minimum wage is \$5 per hour, and the assumed poverty level for a one-adult, two-child family is \$16,000.

TABLE 4

<i>Hourly Wage Rate</i>	<i>Precredit Annual Income</i>	<i>Credit Amount Needed to Raise Disposable Income to \$16,000 (poverty level)</i>
\$5 (minimum wage)	\$10,000	\$6,000
6	12,000	4,000
7	14,000	2,000
8	16,000	0

As the table demonstrates, the appropriate credit amount decreases dollar for dollar as precredit income rises from \$10,000 to \$16,000. In other words, the credit is phased out at the rate of 100% in the \$10,000 to \$16,000 income range.<sup>119</sup> The entire phase-out takes place while precredit income is below the poverty level.

If it is understood by those to whom it applies, a tax rate of 100% obviously produces a dramatic substitution effect. Consider, for example, how a worker with two children and an hourly wage rate of \$8 might respond to the 100% phase-out embodied in the table above. If she works 1,250 hours, she will earn \$10,000 and will qualify for a \$6,000 credit. She could work another 750 hours and increase her precredit income to \$16,000, but that \$6,000 increase would be fully offset by the loss of the entire credit. Alternatively, the 100% phase-

<sup>119</sup> This is analogous to the way in which the effect of a legislated minimum wage phases out. If a worker would have earned \$4 per hour in the absence of a \$5 minimum wage law, the minimum wage produces a \$1 per hour benefit for the worker (assuming the employer does not respond to the law by declining to hire the worker). For a worker who would have commanded a wage of \$5 per hour in the absence of legislation, the law produces no benefit. Thus, the benefit of the law is phased out at the rate of 100% as the worker's hourly wage rate in the absence of legislation rises from \$4 to \$5.

out is grotesquely unfair to a worker who does not understand it, and works an additional 750 hours for nothing. Because of these efficiency and fairness concerns, almost no one—not even most confirmed believers in the unique policy significance of the poverty level—would propose a 100% phase-out rate.<sup>120</sup> A confirmed believer would keep the phase-out, but reduce the rate (and correspondingly expand the range) in response to the objections to confiscatory and near-confiscatory phase-out rates. The result might be something similar to the actual phase-out rules of the EITC.

This approach to justifying the EITC phase-out is not very appealing, however, because it is based on a crabbed view of the appropriate scope of redistribution and on the dubious assumption that the official poverty levels are uniquely significant. The assumption is especially dubious because of the serious technical objections to the method by which official poverty levels are now determined,<sup>121</sup> but the drawing of a bright-line distinction between poor and not-poor would remain dubious even with a more sophisticated definition of poverty-level income. A much more compelling argument for reducing (but not eliminating) the credit as income rises is discussed immediately below.

*D. Achieving Appropriate Differences in Net Transfers or Net Taxes, Based on Family Responsibilities, at Different Income Levels*

Under this Article's theory of the EITC, the amount of the credit for a minimum wage parent should equal the subsistence cost of a child multiplied by the number of children supported by the parent. If the subsistence cost of a child were \$3,000, a parent earning the minimum wage and supporting two children would receive a \$6,000 credit. The idea is that the government should "pick up" the entire subsistence cost of the children of minimum wage workers, so that no family headed by a full-time minimum wage worker should have to live in poverty. Thus, as between two minimum wage workers with the same earned income but different numbers of children, the worker with the larger family should receive a larger net transfer, with the difference between the net transfers equaling the difference in the number of children multiplied by the per child cost of subsistence.

Now consider two high-wage workers, with the same earned income, but with different numbers of dependent children. What is the appropriate difference in their tax liabilities? The traditional analy-

<sup>120</sup> But see Theobald, note 5; Schwartz, note 5 (both proposing 100% phase-outs).

<sup>121</sup> For a thorough and sophisticated critique of the official poverty guidelines, see Patricia Ruggles, *Drawing the Line: Alternative Poverty Measures and Their Implications for Public Policy* (1990).

sis—embodied by the dependency exemption<sup>122</sup>—is that each taxpayer should have to pay tax only on his “clear income”—that is, his income above the income necessary to support his family at a subsistence level.<sup>123</sup> Still assuming that the per child cost of subsistence is \$3,000, this means that the worker with the larger family should have the lower net tax liability, with the difference between the net liabilities equaling the difference in the number of children multiplied by the per child cost of subsistence and multiplied by the taxpayers’ marginal tax rate. If the marginal tax rate is 20%, for example, then the liability of the taxpayer with more children should be lower by \$600 for each additional child—not by \$3,000.

The problem with Shaviro’s argument that the EITC should not be phased out is now apparent. At the minimum wage level the government should pay for the entire subsistence cost of a child, so the EITC should produce a \$3,000 per child difference in the amount of transfer received from the government. It does not follow, however, that the government should finance the entire subsistence cost—or even any of the subsistence cost—of children of higher-wage parents. For those families, the tax system should produce only a \$600 per child difference (for example) in the amount of tax paid to the government. It does not follow from this analysis that the EITC must be phased out. It would be possible, instead, to integrate the EITC with the dependency exemption, and merely to phase down the EITC until it resulted in an appropriate per child difference in tax liabilities for higher income families. Still assuming a \$3,000 per child cost of subsistence and a 20% flat tax rate, this could be done by (1) repealing the dependency exemption, and (2) phasing down the EITC until it reached a floor of \$600. The results would be a \$3,000 per child difference in transfers received by minimum wage workers, and a \$600 per child difference in tax liabilities of high-wage workers. In short, Shaviro is right that there is nothing wrong with a taxpayer with a six- or seven-figure income receiving an EITC, but there *is* something wrong with a \$3,000 per child difference in the tax liabilities of two affluent taxpayers earning the same salary. Reducing the amount of the EITC as income increases is not necessary to achieve vertical equity (that is, to prevent rich people from receiving a subsidy properly aimed at poor people), but it is necessary to achieve horizontal equity (that is, to avoid unduly favoring rich taxpayers with more children vis-a-vis rich taxpayers with fewer children).

Integrating the EITC with the dependency exemption would not be quite so simple in the real world, because of three features of the cur-

---

<sup>122</sup> IRC § 151.

<sup>123</sup> See text accompanying notes 38-42.

rent Code—the phase-out of dependency exemptions for high income taxpayers,<sup>124</sup> the child tax credit,<sup>125</sup> and progressive marginal tax rates. The first complicating factor—the phase-out of dependency exemptions—suggests that the EITC should be phased out, rather than merely down, for very high income taxpayers. The phase out of dependency exemptions, however, has been almost universally decried by tax policy analysts—because of its complexity, because of the marginal tax rate bubbles it creates, and because taxing only “clear income” requires dependency exemptions at all income levels.<sup>126</sup> In response to the critics, Congress has provided for the phase-out itself to be phased out in 2010.<sup>127</sup> With the recent legislative acceptance (at least in principle) of not phasing out the dependency exemption, it also should be acceptable to integrate the EITC with the dependency exemption by phasing the EITC down, but not out.

Since 1997, most parents of dependent children have been entitled to claim a child tax credit for each child, in addition to a dependency exemption.<sup>128</sup> The credit amount is currently \$1,000 per child, and eligibility for the credit is phased out for higher income parents.<sup>129</sup> The policy rationale for the credit is somewhat obscure. According to the legislative history, the credit was enacted out of a belief that dependency exemptions are too small to produce appropriate reductions in tax liability as family size increases.<sup>130</sup> The legislative history does not explain why Congress did not simply increase the amount of the dependency exemption, if it believed the exemption amount was inadequate.<sup>131</sup> It is fairly clear, however, that the choice of a new credit

---

<sup>124</sup> IRC § 151(d)(3), discussed in the text accompanying note 41.

<sup>125</sup> IRC § 24, discussed in the text accompanying notes 25-35.

<sup>126</sup> See, e.g., Martin J. McMahon, Jr., *Individual Income Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 Wash. & Lee L. Rev. 459, 475 (1993); Robert J. Peroni, *Reform of the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 Tax Notes 1415 (May 28, 2001).

<sup>127</sup> IRC § 151(d)(3)(E), (F). Without further legislation, however, the phase-out of dependency exemptions will reappear in 2011. Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

<sup>128</sup> IRC § 24, discussed in the text accompanying note 32.

<sup>129</sup> The phase-out begins at \$110,000 adjusted gross income for a married couple filing a joint return, and at \$75,000 for unmarried taxpayers (with adjustments for post-2001 inflation). IRC § 24(b).

<sup>130</sup> The Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases. In part, this is because over the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Committee believes that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values.

H.R. Rep. No. 105-148, at 310 (1997), reprinted in 1997-4 C.B. (vol. 1) 319, 632.

<sup>131</sup> Perhaps Congress believes that the real subsistence cost of a child is more than the dependency exemption amount, and that the combination of the dependency exemption

over an enlarged exemption amount was in response to the critique of exemptions as “upside-down” subsidies. According to that critique, it is objectionable that a \$1,000 increase in the exemption amount would result in a tax savings of \$350 for an affluent parent in the 35% bracket, but a tax savings of only \$100 for a struggling parent in the 10% bracket.<sup>132</sup> In fact, the upside-down subsidy critique does not properly apply to dependency exemptions, because dependency exemptions are not subsidies, but are rather a means of determining the amount of income on which a taxpayer should be required to pay tax. If the subsistence cost of a child is \$3,000, then a taxpayer with a child has \$3,000 less “clear income” than an otherwise identical childless taxpayer, and should have \$3,000 less taxable income. An exemption, not a credit, is the appropriate tool to produce that result.<sup>133</sup>

Whatever the policy merits or demerits of the child tax credit, Congress seems content with the family size differences in tax liabilities for middle-income taxpayers created by the combination of dependency exemptions and the child tax credit. Roughly speaking, then, Congress has decided that the per child reduction in tax liability for a middle-income taxpayer should be about \$1,750 (\$750 as a result of a \$3,000 dependency exemption claimed in the 25% bracket, and \$1,000 as a result of a \$1,000 credit). For upper income taxpayers, Congress has decided that the per child reduction in tax liability should be about \$1,000 (\$1,050 as a result of a \$3,000 dependency exemption claimed in the 35% bracket,<sup>134</sup> and no child tax credit because of the credit’s phase-out).

Taking those legislative determinations as given, and starting from a \$3,000 per child EITC for minimum wage workers, it should be possible to integrate the EITC, the dependency exemption, and the child tax credit into a single child tax benefit. The per child amount of the integrated benefit would be \$3,000 at the poverty level, would be phased down to \$1,750 for middle income taxpayers, and further

---

amount and the exemption-equivalent of the child tax credit approximates the real subsistence cost. This view is at least hinted at by the language from H.R. Rep. No. 105-148, quoted in the preceding footnote. If so, this implies that the real subsistence cost of a child, for a taxpayer in the 25% bracket, is approximately \$7,000: the \$3,100 exemption amount, plus the \$4,000 exemption-equivalent of a \$1,000 credit. If Congress really believes this, it would seem that the per-child EITC amount also should be about \$7,000, rather than approximately \$3,000 as suggested in this Article.

<sup>132</sup> See Harvey E. Brazer, *The Federal Income Tax and the Poor: Where Do We Go From Here?*, 57 Cal. L. Rev. 422, 441 (1969) (explaining that the tax benefit from a dependency exemption is greatest for a taxpayer in the highest rate bracket).

<sup>133</sup> See text accompanying note 40 (explaining the “clear income” concept). Of course, it is possible that a pro-family or pro-natalist Congress wants to subsidize children, in which case a credit would be an appropriate tool.

<sup>134</sup> This reflects the law as scheduled for 2010, when the phase-out of dependency exemptions will not apply.

phased down to \$1,000 for upper income taxpayers.<sup>135</sup> EITC integration proposals along these lines in fact have been made by Robert Cherry and Max Sawicky,<sup>136</sup> and by David T. Ellwood and Jeffrey B. Liebman.<sup>137</sup>

It would be possible to design the interaction of the phase-down of the credit and the regular tax rates imposed by § 1 so that few taxpayers would be subject to marginal tax rate bubbles. As an illustration, suppose § 1 imposes tax at the rate of 10% on the first \$25,000 of taxable income, and that the tax rate in the next bracket is 25%. The phase-down of the per child credit from \$3,000 at the poverty level to \$1,750 in the middle-income range could be designed to coincide precisely with the income range of the 10% bracket. For example, the per child credit could be reduced by \$50 for every \$1,000 of taxable income, in the taxable income range of zero to \$25,000.<sup>138</sup> At taxable income of \$25,000, this would produce a per child credit of \$1,750.<sup>139</sup> Only a childless taxpayer would face an effective marginal tax rate of 10% on the first \$25,000 of taxable income, followed by a 25% rate bracket. A taxpayer with one child would have an effective tax rate of 15% (10% under § 1 and 5% from the phase-out) on the first \$25,000 of taxable income, followed by the 25% bracket. A taxpayer with two children would face an initial effective rate of 20%, followed by 25%, and a taxpayer with three children would face the 25% rate starting with the first dollar of taxable income. Only a taxpayer with more than three children would be subject to a rate bubble. The trick is simply to leave enough “room” in the lowest § 1 rate bracket—in terms of both the income range of the bracket and the difference between that bracket’s rate and the next rate—to accommodate the desired

---

<sup>135</sup> One attractive feature of this integration is that it would eliminate the near absurdity of the partly offsetting phase-out of the EITC and phase-in of CTC refundability under current law (described in text accompanying notes 29-35).

<sup>136</sup> Robert Cherry & Max Sawicky, *Giving Tax Credit Where Credit Is Due: A “Universal Unified Child Credit” That Expands the EITC and Cuts Taxes for Working Families* (Econ. Pol’y Inst., Briefing Paper No. 91, 2000), available at <http://www.epinet.org/content.cfm?id=831>.

<sup>137</sup> David T. Ellwood & Jeffrey B. Liebman, *The Middle-Class Parent Penalty: Child Tax Benefits in the U.S. Tax Code*, 15 *Tax Pol’y & Econ.* 1, 29 (2001).

<sup>138</sup> Taxable income is determined after the application of the standard deduction and the taxpayer’s own personal exemption. As long as the sum of the standard deduction and the taxpayer’s own exemption was at least equal to the maximum amount of credit-eligible earned income (for example, \$10,000), starting the phase-out at zero taxable income would not result in an overlap of the phase-in and phase-out ranges of the credit.

Current law features one-child and two-children EITC “plateaus”—income ranges of several thousand dollars between the end of the phase-in of the credit and the beginning of the phase-out. IRC § 32(b)(2). If similar plateaus are desired for the integrated child tax benefit, the phase-out might start at taxable income of several thousand dollars, rather than taxable income of zero.

<sup>139</sup>  $\$3,000 - (25 \times \$50) = \$1,750$ .

credit phase-down without producing a rate bubble. The trick could be repeated, at a higher income level, to reduce the per child credit from \$1,750 to \$1,000 without a bubble effect. Of course, phase-outs and phase-downs can be criticized for producing high effective marginal tax rates, even if they do not produce bubbles, so the proposed trick is not a panacea. On the other hand, the effective marginal tax rates need not be particularly high under the proposed approach, because the phase-down has modest work to do compared to a phase-out, and because the two-step nature of the phase-down means the effect can be spread over a wide income range.

## V. EITC MARRIAGE PENALTIES

### A. *EITC Marriage Penalties Under Current Law and Under the Proposed Reform*

This Article has suggested a rationalized version of the EITC, under which a parent working full time at the minimum wage would be entitled to a credit equal to the cost of supporting a child at the subsistence level (for example, \$3,000), multiplied by the number of the parent's dependent children. By integrating the credit with the child tax benefits available to higher income parents—the child tax credit and the dependency exemption—the need to phase out the credit would be eliminated. Instead, as income increased above the annual minimum wage, the amount of the unified per child tax benefit would be phased down, to achieve the desired family size-based differences in tax liabilities at higher income levels.

To this point the analysis has proceeded as if all credit-eligible parents were single, thus avoiding issues of marriage penalties and singles penalties in the design of the EITC. This Section considers whether the proposed revision of the EITC would improve current law by achieving equity between unmarried and married credit recipients.

The current EITC has two sources of marriage penalties. First, the credit takes into account the existence of only two children, regardless of whether parents are married or single. If one minimum wage worker with two children of her own marries another minimum wage worker with two children of his own, they will go from being able to claim credits based on four children before the wedding, to being able to claim credits based on only two children after the wedding. The same penalty would result if two unmarried workers, living together

with their four children, obtain a marriage license.<sup>140</sup> A second source of marriage penalties is the design of the phase-out of the credit.<sup>141</sup>

To see the combined effect of these two penalty sources, consider two single parents, each with \$12,000 earned income and each supporting two children. Assume an EITC structure that is basically that of current law, with the numbers rounded for ease of illustration: (1)

---

<sup>140</sup> When unmarried parents live together with their own (shared) children, the parents may divide the children between them in any way they choose, for EITC purposes. See IRC § 32(c)(3)(A) (incorporating IRC § 152(c)(1), under which a child living with both unmarried parents is a “qualifying child” of each parent). For example, an unmarried couple with four children could claim two two-children EITCs, by allocating two children to each parent. Even if the couple had only two children, allocating one child to each parent would enable the couple to take advantage of the fact that two one-child credits are greater than one two-children credit. See IRS Publication No. 596, *Earned Income Credit* 15-16 (2003) (indicating either parent may claim a child who is a qualifying child of each, and *not* indicating that all children must be allocated to the same parent). The rule of § 152(c)(4)(B)(ii) (incorporated by § 32(c)(3)(A)), allocating a qualifying child to the higher-income parent, applies only when the parents cannot agree on the allocation. Significant marriage penalties result from the combined effect of the two-children ceiling and the allocation flexibility afforded unmarried parents. A two-earner married couple with four children, for example, could increase the number of credit-generating children from two to four, simply by obtaining a divorce, continuing to live together, and allocating two children to each parent for EITC purposes.

When unmarried cohabitants do not share the parentage of the children with whom they reside, there is no flexibility in EITC allocation; each child is assigned to that child’s parents. Nevertheless, spouses with unshared children are also subject to EITC marriage penalties due to the two-child ceiling. In a household consisting of a wife with two children of her own, and a husband with two children of his own, the EITC is based on only two children. If they obtained a divorce and continued to live together the couple could obtain credits based on four children.

Until 1990, an unmarried taxpayer could claim an EITC only if the taxpayer qualified for surviving spouse or head of household filing status. See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11,111(a), 104 Stat. 1388, 1410 (amending IRC § 32(c)(1)(A) to eliminate the rule that the EITC could be claimed only by a surviving spouse, a head of household, or by a married couple filing a joint return). Since only one unmarried cohabitant could qualify as the head of the household, only one cohabitant could claim the EITC. A return to the pre-1990 rule would remove a major source of EITC penalties under current law, as a married couple then could not increase the number of credit-generating children by divorcing and continuing to live together. (The two-child ceiling on credit-generating children would continue to produce marriage penalties, however, relative to the option of divorce followed by a break-up of the family into two households, with at least one child residing with each parent.) In fact, one commentator has proposed a return to pre-1990 law as a form of marriage penalty relief. Frederick J. Bradshaw IV, Note, *The Earned Income Tax Credit and the Marriage Penalty: New Proposals in Light of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 54 *Tax Law* 701, 715 (2001). From the perspective of the EITC proposal in this Article, a return to pre-1990 law is not an attractive form of marriage penalty relief. Instead of removing an inappropriate limitation on the amount of credit available to married parents, a return to pre-1990 law would impose an inappropriate new limitation on unmarried parents.

<sup>141</sup> Because it depends on the *combination* of earned income and dependent children, the current EITC also can produce marriage bonuses. If a person with two children and no income marries a person with \$10,000 income and no children, the bringing together of children and income will create a credit where none existed before.



for a taxpaying unit (a single parent or a married couple) with two or more children, the maximum credit amount is \$4,000, and (2) the credit is phased out at the rate of 20%, with the phaseout starting at \$14,000 income for an unmarried parent and at \$15,000 in the case of a joint return. As unmarried credit claimants, the two unmarried parents are entitled to a combined credit amount of \$8,000. If they were to marry, however, the first marriage penalty source—the two-child cap on credit-generating children—would reduce their combined credit to \$4,000, thus producing a \$4,000 marriage penalty. The second penalty source—the phase-out—would reduce their credit by an additional \$1,800,<sup>142</sup> leaving them with a final credit amount of only \$2,200. Their total EITC marriage penalty is \$5,800 (\$8,000 - \$2,200), almost a quarter of their combined earned income.

Marriage penalties would be considerably less severe under the proposed EITC revision. The proposal would eliminate the first source of EITC marriage penalties, by removing the cap on the number of children taken into account in calculating the credit. If this approach proved politically impossible, there is an alternative that also would eliminate this source of marriage penalties—the doubling of the ceiling on credit-generating children for a couple filing a joint return. If the cap remained at two children for single parents, it would be raised to four children for a married couple. This would create a singles' penalty, however, for any unmarried parent with three or more children.

The phase-out aspect of the EITC marriage penalty is an instance of the general problem of achieving fairness between married and unmarried taxpayers in a tax system featuring progressive marginal rates and joint filing by married couples.<sup>143</sup> In such a system there is no way to avoid having marriage penalties, singles penalties, or both. To illustrate the possibilities, assume the phase-out (at the rate of 20%) of the \$4,000 maximum credit is to begin at the \$12,000 income level in the case of an unmarried parent. If the phase-out also begins at \$12,000 for a married couple, the result will be significant phase-out-

---

<sup>142</sup>  $(\$24,000 - \$15,000) \times 20\% = \$1,800$ .

<sup>143</sup> The joint filing system for married couples serves the goal of couples neutrality, that is, equal tax liabilities (or equal transfer payments) for couples with equal incomes, regardless of how income is distributed between the husband and the wife within each marriage.

The problem is that it is impossible, as a matter of arithmetic, to have a tax system that has all three of the following features: (1) progressive marginal tax rates, (2) couples neutrality, and (3) marriage neutrality (that is, marriage neither increasing nor decreasing a couple's tax liability, compared with their combined liabilities if unmarried). For good explanations of the incompatibility of these three features, see *Tax Treatment of Single Persons and Married Persons Where Both Spouses Are Working*, Hearings Before the House Comm. on Ways and Means, 92d Cong. 78-79 (1972) (statement of Edwin S. Cohen, Ass't Treas. Sec'y, Tax Pol'y); Staff of Joint Comm. on Tax'n, 96th Cong., *The Income Tax Treatment of Married Couples and Single Persons* 4 (Comm. Print 1980); Boris I. Bittker, *Federal Income Taxation and the Family*, 27 *Stan. L. Rev.* 1389, 1395-96 (1975).

created marriage penalties. For example, if a parent with \$12,000 income and two children married a person with \$12,000 income and no children, the EITC would decrease from \$4,000 to \$1,600.<sup>144</sup> The same parent would not face a marriage penalty if, instead, the phase-out threshold for a married couple were set at \$24,000—twice the phase-out threshold for a single parent.<sup>145</sup> The problem with this approach is that it creates large singles penalties. A married couple with \$24,000 income is not subject to the phase-out tax, but a single parent earning \$24,000 is burdened by a phase-out tax of \$2,400.<sup>146</sup>

If the phase-out threshold for married couples is set higher than the threshold for single parents, but less than twice as high, there will be both marriage penalties and singles' penalties, but the penalties will be smaller than under either of the more one-sided approaches.<sup>147</sup> By providing a joint return phase-out threshold slightly higher than the phase-out threshold for single parents,<sup>148</sup> current law adopts a version of this compromise approach, but it is a version not far removed from the marriage penalties-only approach.

The two-fold lesson to be drawn from the preceding analysis is rather discouraging: (1) As long as there is joint filing by married

---

<sup>144</sup> Before the marriage, the parent would be entitled to the maximum two-child credit of \$4,000. At the \$12,000 income level, the phase-out would not apply. After the marriage, the phase-out, based on \$24,000 of joint return income, would reduce the amount of the credit by \$2,400  $((\$24,000 - \$12,000) \times 20\% = \$2,400)$ .

<sup>145</sup> The phase-out would not apply at the \$24,000 joint return income level. Thus, the credit amount would be \$4,000, with or without marriage.

When considering marriage penalties caused by the basic rate structure of § 1, doubling bracket widths for married couples is sufficient to eliminate all potential marriage penalties. See Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 Tax L. Rev. 1, 21-22 (2000). The equivalent approach would not eliminate all potential for marriage penalties in the EITC, however, because of the fact that the application of the phase-out tax depends on the combination of income and children. Suppose, for example, the phase-out threshold were set at \$12,000 for a single parent and at \$1 million for a married couple. Even then, there would be potential for a marriage penalty—for example, if a parent with \$12,000 income married a childless person with a seven-figure income.

<sup>146</sup>  $(\$24,000 - \$12,000) \times 20\% = \$2,400$ .

<sup>147</sup> Suppose, for example, the joint return phase-out threshold is set at \$18,000, while the threshold for single parents remains \$12,000. Then the hypothetical couple described in the text—one the parent of two children, one with no children, and each earning \$12,000—will be subject to a \$1,200 penalty if they are married. If they were unmarried, the phase-out would not apply to a single parent with \$12,000 income. If they are married, the phase-out tax will be  $(\$24,000 - \$18,000) \times 20\% = \$1,200$ . At the same time, a single taxpayer earning \$18,000 and supporting two children would be subject to a singles penalty of \$1,200. If she were married to a spouse with no income, the phase-out would not apply to their joint return income of \$18,000, but as a single taxpayer she is subject to a phase-out tax of  $\$1,200((\$18,000 - \$12,000) \times 20\%)$ .

<sup>148</sup> The joint return phase-out threshold is currently \$1,000 higher than the phase-out threshold for unmarried taxpayers. The difference in the thresholds is scheduled to increase to \$2,000 in 2005, and to \$3,000 in 2008. IRC § 32(b)(2)(B).

couples and the EITC is phased out (or phased down) as income increases, the phase-out cannot be marriage-neutral; and (2) there is no way to arrive at any one “right” answer, among the innumerable possible allocations of marriage penalties and bonuses.<sup>149</sup> The EITC revision proposed in this Article would not make this source of marriage non-neutrality disappear, but it would lessen the severity of the problem. By replacing the phase-out with a phase-down, it reduces the amount of the potential penalty to be distributed between single and married parents. As described earlier,<sup>150</sup> except for high income parents, the per child EITC amount would be subject to a phase-down of only \$1,250 (\$3,000 - \$1,750). Reducing the maximum amount of the phase-out tax reduces the potential amounts of marriage and singles penalties. When this effect is combined with the elimination of the other source of marriage penalties (the cap on the number of credit-generating children), the proposed EITC revision offers a considerable improvement over current law in marriage penalty terms. This is a serendipitous result, since the proposed revisions are motivated primarily by the goal of rationalizing the basic structure of the credit, not by a special concern with alleviating marriage penalties.

### *B. A Spousal EITC?*

One might take the position that a person working full-time at the minimum wage should be able to support not only his children, but also his spouse, at the subsistence level. Under this view, a minimum wage worker with an unemployed spouse and two children would be entitled to three credits. (The spousal credit amount might be more than the per child credit amount to reflect the greater subsistence needs of an adult.) Highly contestable values are involved here. Few would argue, today, that a government subsidy is appropriate to sup-

---

<sup>149</sup> Some commentators have suggested reducing marriage penalties created by the phase-out of the EITC not by increasing the joint return phase-out threshold relative to the single parent phase-out threshold, but by instituting a two-earner deduction for purposes of the phase-out tax. For example, in calculating the amount of income above the phase-out threshold, a married couple might be allowed a deduction equal to 20% of the income of the lower-earning spouse. At the extreme, there might be a 100% two-earner deduction; in other words, the phase-out might be based solely on the income of the higher-earning spouse. See Janet Holtzblatt & Robert Rebelein, *Measuring the Effect of the EITC on Marriage Penalties and Bonuses*, 53 Nat'l Tax J. 1107, 1130 (2000) (describing the two-earner deduction approach and analyzing the economic effects of a 20% deduction and a 100% deduction). Any two-earner deduction violates the principle of couples neutrality routinely used to justify joint filing. That is, with a two-earner deduction two couples with equal combined incomes will not receive the same size EITC if the spousal shares of the combined incomes are different in the two marriages. The 100% deduction violates couples neutrality in a particularly spectacular fashion.

<sup>150</sup> See text accompanying note 135.

port the able-bodied spouse of a childless minimum wage worker.<sup>151</sup> If a spousal credit is to be provided at all, it should apply only when the couple has dependent children cared for by the unemployed spouse. Even then, distinctions might be drawn based on the children's ages. Perhaps a spousal EITC is appropriate as long as at least one child is below school age, but not thereafter.

Even where the case for a spousal EITC is strongest—for the parents of infants or toddlers—there is not a clear societal consensus that a full-time minimum wage worker's earnings, as supplemented by the EITC, should be sufficient to support both the worker's children and a stay-at-home spouse. The political reaction to a proposal for a spousal EITC is hard to predict. Would conservatives oppose it based on a general opposition to increased redistribution, or would they support it because it promotes their favored model of the family? Conversely, would liberals oppose the proposal because it reinforces gender role stereotypes,<sup>152</sup> or would they support it for its redistributive effects?<sup>153</sup>

Of course, some low-wage parents share wage-earning and child care responsibilities, and the design of a spousal EITC should not penalize them vis-a-vis low-wage parents with a sharp division of labor. If a spousal credit is allowed, then, it should be just as available to a couple each working half-time at the minimum wage and sharing child care duties, as to a couple in which one spouse is employed full-time and the other is a full-time caregiver. It follows that the spousal credit calculation should be based solely on: (1) the existence of the married

---

<sup>151</sup> For a contrary view, from a progressive reformer writing in 1925, see Paul H. Douglas, *Wages and the Family* 211 (1925). The Douglas proposal, an important precursor of the version of the EITC proposed in this Article, is described in detail in the Appendix.

<sup>152</sup> A spousal EITC would be formally gender neutral. That is, it would be available in the case of an employed wife and a caregiving husband. Nevertheless, one would expect the substantial majority of spousal credits to be awarded to couples with employed husbands and caregiving wives.

<sup>153</sup> The "living wage" and "family wage" movements in 19th and early 20th century United States advocated wages for working men adequate to support a wife and several children in comfort. For a comprehensive history, see Lawrence B. Glickman, *A Living Wage: American Workers and the Making of Consumer Society* (1997). These movements created a quandary for early feminists, similar to the quandary a proposal for a spousal EITC might create:

Female labor reformers [of the 1920s and 1930s] . . . found themselves caught on the horns of a dilemma. On the one hand, they recognized that many women went to work and kept working and that they required training and equal pay. On the other hand, they were committed ideologically to the concept of the family wage [for men], a staple in the reformist diet.

Jean Bethke Elshtain, *The Family Crisis, the Family Wage, and Feminism: Historical and Theoretical Considerations*, in *The Family Wage: Work, Gender, and Children in the Modern Economy* 59, 69 (Bryce J. Christensen ed., 1988) [hereinafter *The Family Wage*].

couple, (2) the existence of dependent children (perhaps below some specified age), and (3) the combined earnings of the spouses.<sup>154</sup>

A spousal EITC is appropriate if, and only if, society believes a full-time minimum wage worker should be able to support both his children and a full-time caregiver spouse. If a spousal EITC were adopted, however, it would have the attractive side effect of alleviating the EITC marriage penalty problem.<sup>155</sup> The spousal EITC would be available, of course, only in the case of a married couple. The marriage bonus created by the spousal EITC would counteract the marriage penalty caused by the EITC phase-down, in some cases resulting in a smaller net marriage penalty, and in other cases creating a net marriage bonus. In the following example of a spousal EITC in the context of the type of EITC proposed in this Article, the net effect happens to be a marriage bonus. Assume the maximum per person EITC amount is \$3,000 for both the child EITC and the spousal EITC. The \$3,000 maximum per person credit amount is reached at \$10,000 of earned income, and the phase-down begins at \$12,000 (that is, there is a credit “plateau” from \$10,000 to \$12,000 income). The phase-down reduces the per person credit amount by \$5 for every \$100 of income above the \$12,000 threshold. The \$12,000 phase-down threshold is the same for married and unmarried parents, so the phase-down itself produces only marriage penalties. The parents are a couple with one child, earning \$12,000 each (and sharing child care responsibilities). Table 5 summarizes the EITC results for the parents in three situations: (1) if the parents are unmarried; (2) if the parents are mar-

---

<sup>154</sup> As with the per child credit, the amount of the spousal credit would vary with the couple's income, during both the phase-in range and the phase-down (or phase-out) range. The phase-down analysis of the per child credit, see text accompanying notes 135-39, would have to be modified for the spousal credit, because there is no spousal equivalent of the child tax credit with which the spousal EITC could be integrated. The spousal credit could still be integrated with the spousal personal exemption, but this would require a larger phase-down than if there were a spousal equivalent of § 24. It might be possible, however, to decrease the size of the necessary phase-down by integrating the phase-down with both the spousal personal exemption and the excess of the joint return standard deduction over the head of household standard deduction provided for in § 63(c).

<sup>155</sup> As with many forms of marriage penalty relief, the spousal EITC could be criticized as creating a singles penalty. The argument would be (for example) that an unmarried minimum wage worker with one child is penalized by receiving a smaller credit than a married minimum wage worker with one child and an unemployed caregiver spouse. The response to the argument would be two-fold. First, if the unmarried worker needs to support only one other person while the married worker needs to support two other persons, the difference in credit amounts is justified by the difference in circumstances. The unmarried worker is not penalized thereby, any more than a worker supporting only one child is penalized by receiving a smaller credit than a worker supporting two children. Second, if the unmarried worker does need to support two other people, because the worker cohabits with an unemployed caregiving parent, the worker can and should avoid the singles penalty by marrying the caregiving parent.

ried and there is no spousal EITC, and (3) if the parents are married and there is a spousal EITC. As the table shows, if there is no spousal EITC the parents face a marriage penalty of \$600. If there is a spousal EITC, however, they are presented with a marriage bonus of \$1,800, as the marriage bonus from the spousal EITC more than offsets the marriage penalty from the phase-down.

TABLE 5

<i>Marital Status and Spousal Credit Rule</i>	<i>Credit Amount Before Phase-down</i>	<i>Phase-down "Tax"</i>	<i>Credit Amount After Phase-down</i>	<i>Marriage Penalty or Bonus</i>
Unmarried <sup>156</sup>	\$3,000	0	\$3,000	NA
Married, no spousal credit allowed	3,000	600 <sup>157</sup>	2,400	\$ 600 penalty
Married, spousal credit allowed	6,000	1,200 <sup>158</sup>	4,800	1,800 bonus

## VI. CONCLUSION

Congress has never offered a coherent account of the purpose (or purposes) of the EITC, and the structure of current law does not suggest any well-defined purpose. The somewhat incoherent nature of current law might be the result of a compromise between conflicting visions of the credit's purpose, rather than the lack of any clear vision, but it is difficult or impossible to find attractive accounts of the purpose of the credit even in the academic literature.

This Article has argued that the EITC can and should be redesigned to serve as an adjustment to the minimum wage based on family size, to lift all families headed by full-time workers out of poverty. Although this view of the EITC would inform a redesign of the credit, it would certainly not dictate every element of credit design. People might agree on this basic goal for the credit and still disagree on many structural details, such as: (1) whether the maximum amount of the credit should be tied to the official poverty guidelines, (2) whether there should be some limit on the number of credit-generating children for any one household, (3) how rapidly the credit should be phased in and phased down, (4) how far the credit should be phased down (that is, what are appropriate differences in tax liability based

<sup>156</sup> Since the two parents have equal incomes, it makes no difference which parent claims the credit. Each parent has sufficient income to qualify for the maximum credit, and insufficient income to be subject to the phase-down.

<sup>157</sup>  $(\$24,000 - \$12,000) \times 5\% = \$600$ .

<sup>158</sup>  $(\$24,000 - \$12,000) \times 5\% \times 2 = \$1,200$ .

on family size, for middle and upper income taxpayers), (5) whether the credit design should be based on the assumption that the de facto minimum wage for working parents exceeds the official minimum wage, (6) whether there should be special credit rules for parents of young children, based on the view that such parents should not be employed full-time, (7) whether the credit should be designed to cover the subsistence needs of a worker's homemaking spouse, as well as those of the worker's children; and (8) whether the minimum wage-adjusting aspect of the credit should be combined with or separated from any payroll tax relief for low wage workers. Despite these numerous and important open questions, viewing the credit as a minimum wage adjustment could be the first step in the development of a more rational and more effective anti-poverty program for working families.

## APPENDIX

TWO HISTORICAL ANTECEDENTS FOR THE PROPOSED  
VERSION OF THE EITC

Although Congress has never articulated the idea of the EITC as a family-size adjustment to the minimum wage, and the design of the current EITC is not wholly consistent with that idea, the concept of minimum wage supplements based on family responsibilities has a considerable history. This Appendix describes two important antecedents of the version of the EITC proposed in this Article: allowances in aid of wages in 18th and 19th century England, and a proposal made in 1925 by Paul H. Douglas.

*A. The Speenhamland System*

In 1795, Berkshire, England, introduced the Speenhamland system—a program of poverty relief allowances bearing a striking resemblance to the proposed version of the EITC. The system provided for the fixing of official poverty levels, based on the size of a family and on the current price of bread. To the extent the earnings of any “poor and industrious man” fell below his family’s poverty level, the difference was to be made up by a cash grant from the County:

When the gallon loaf of second flour weighing 8 lb. 11 oz. shall cost 1s., then every poor and industrious man shall have for his support 3s. weekly, either produced by his own or his family’s labour or an allowance from the poor rates, and for the support of his wife and every other of the family 1s. 6d.

When the gallon loaf shall cost 1s. 4d., then every poor and industrious man shall have 4s. weekly for his own, and 1s. 10d. for the support of every other of his family.

And so on in proportion as the price of bread rises or falls (that is to say) 3d. to the man and 1d. to every other of the family on every penny which the loaf shall rise above a shilling.<sup>159</sup>

If the wage rate happened to be just enough to support a single worker at the subsistence level, then the Speenhamland system would produce results equivalent to the version of the EITC proposed herein. Whatever the size of the worker’s family, his full-time wage plus his allowance would be just enough to support his family at the

---

<sup>159</sup> Anthony Brundage, *The English Poor Laws, 1700-1930*, at 28 (2002) (quoting Sidney Webb & Beatrice Webb, *English Poor Law History, Part III: The Last Hundred Years 178 (1927)*).



poverty level. There were, of course, a number of differences between the Speenhamland system and the proposed EITC. First, the Speenhamland system was not premised on any particular relationship between the going (that is, minimum) wage rate and the cost of subsistence. Even a single worker would be entitled to an allowance if his wages fell below the subsistence level. Conversely, when the wage rate was high relative to the price of bread, even a married worker with several children might receive no allowance.

A second difference was that the Speenhamland allowance was not phased in as earned income rose above zero. Instead, the allowance was available even to a man with very low or no income, as long as the man was “industrious”—that is, as long as his unemployment or underemployment was the result of the unavailability of work rather than an idle nature. As suggested elsewhere in this Article, the phase-in of the EITC is premised on the inability of the Service to observe the industriousness (or lack thereof) of credit claimants.<sup>160</sup> If the administrator of the Speenhamland system was able to make accurate determinations of industriousness, then tying eligibility to those determinations would have been preferable to the EITC’s use of the existence of earned income as a surrogate for industriousness.

Finally, the Speenhamland system, unlike the proposed EITC, featured a confiscatory (100%) phase-out. The allowance was decreased dollar for dollar as a worker’s earnings approached his family’s poverty level. Although such a draconian phase-out would be disastrous in a credit administered through the federal income tax,<sup>161</sup> again it makes good sense if the administrator is able to make accurate determinations of industriousness. A worker will not be discouraged from working because of the 100% phase-out rate, if his lack of industriousness will be observed and will result in the denial to his family of any allowance whatsoever.

Taken together, the absence of a phase-in and the 100% phase-out rate give the Speenhamland system a closer formal resemblance to a guaranteed minimum income—under which the government promises to make up the difference between a person’s income (if any) and the official poverty level—than it does to the proposed EITC. The differences between the Speenhamland system and the proposed EITC, however, are due to the difference between the Speenhamland administrator’s ability to determine industriousness and the inability of the Service to do the same.

Although Berkshire’s Speenhamland system achieved a unique fame, similar systems were in operation in many parts of England dur-

---

<sup>160</sup> See text accompanying notes 75-76.

<sup>161</sup> See text accompanying notes 119-20.

ing the late 18th and early 19th centuries.<sup>162</sup> Speenhamland-style allowances generated tremendous criticism, perhaps most notably from Thomas Robert Malthus and David Ricardo.<sup>163</sup> Malthus and Ricardo both believed that such relief would serve only to encourage population growth and perpetuate poverty. According to Malthus, the “first obvious tendency is to increase population without increasing the food for its support. A poor man may marry with little or no prospects of being able to support a family without parish assistance. [Assistance programs] may be said, therefore, to create the poor which they maintain.”<sup>164</sup> Ricardo concurred: “By engaging to feed all who may require food you in some measure create unlimited demand for human beings.”<sup>165</sup> Largely in response to such criticisms, Speenhamland-style allowances had virtually disappeared by the late 1820’s or early 1830’s.<sup>166</sup>

### *B. Paul H. Douglas and Family Allowances*

Writing in 1925, University of Chicago economist (and later Senator) Paul H. Douglas proposed a system of family allowances closely resembling the version of the EITC proposed in this Article.<sup>167</sup> Doug-

---

<sup>162</sup> See Brundage, note 159, at 28-29 (mentioning a number of similar systems, but cautioning that “[f]ar from being a pervasive form of poor relief, it was applied only in certain districts and only at certain times of the year”); Alan Kidd, *State, Society and the Poor in Nineteenth-Century England* 15-16 (1999) (noting that Speenhamland-style allowances in aid of wages were “a temporary expedient adopted during subsistence crises,” and that the prevalence of such allowances waxed and waned several times between the 1790’s and the early 1830’s); Mark Neuman, *The Speenhamland County: Poverty and the Poor Laws in Berkshire 1782-1834*, at 75-79 (1982) (describing antecedents of the Speenhamland system).

<sup>163</sup> For good summaries of contemporary criticisms of Speenhamland-type allowances, see Kidd, note 162, at 19-24; Brundage, note 159, at 29-36; Allan C. Carlson, *The Family Wage Problem, 1750-1940*, in *The Family Wage*, note 153, at 9, 10-15.

<sup>164</sup> Thomas Robert Malthus, *An Essay on the Principle of Population* 100 (Donald Winch ed., Cambridge Univ. Press 1992)(1803).

<sup>165</sup> David Ricardo, 8 *Works of David Ricardo* 125, quoted in Samuel Hollander, *The Economics of David Ricardo* 564 (1979) (letter from Ricardo to Trower, Jan. 27, 1817).

Writing several decades later, after Speenhamland-style allowances had disappeared, John Stuart Mill joined in the chorus of condemnation of “[t]his deplorable system, worse than any other form of poor law abuse yet invented, inasmuch as it pauperizes not merely the unemployed part of the population but the whole.” John Stuart Mill, *Principles of Political Economy With Some of Their Applications to Social Philosophy* 368 (Sir W.J. Ashley ed., Longmans, Green & Co. 1923) (1871). According to Mill, “Under the allowance system the people increased so fast, and wages sank so low, that with wages and allowances together, families were worse off than they had been before with wages alone.” *Id.*

<sup>166</sup> Brundage, note 159, at 65 (allowances in aid of wages “had largely died out during the 1820s”); Kidd, note 162, at 15 (allowances had “virtually disappeared by 1832”), 23-24 (“The critical literature on the unreformed Poor Law was taken seriously at the highest levels.”).

<sup>167</sup> Douglas, note 151.

las developed his proposal in response to the living wage movement, which claimed (according to Douglas) that “men should be paid enough to maintain a ‘standard’ family of five.”<sup>168</sup> He argued that setting the minimum wage high enough to support that large a family “would probably be impossible,” and that few workers had families that large.<sup>169</sup> A minimum wage based on the assumption of four dependents for each working man “would mean paying for no less than 48,000,000 fictitious dependents” (or 72,000,000, if the same minimum wage applied to women).<sup>170</sup> Douglas posed a rhetorical question: “Should not the real principle be that as needs are not uniform, but variable, so the minimum wage should not be uniform, but should vary according to the needs of the worker and his family?”<sup>171</sup>

Douglas proposed setting the minimum wage at a level sufficient to support a worker with no family responsibilities,<sup>172</sup> and supplementing this wage with allowances based on family size. His allowances would have been paid to mothers, rather than to the employed fathers, because money paid to mothers would be “more likely to be expended for the benefit of the child.”<sup>173</sup> He proposed giving a minimum wage worker (more precisely, the worker’s wife) a per child annual allowance of \$200, an amount intended to approximate the subsistence needs of a child.<sup>174</sup> He also proposed a slightly larger annual allowance, of \$240 or \$250, to cover the subsistence needs of the wife of a minimum wage worker, if the wife “has children to care for.”<sup>175</sup>

Whether there also should be an allowance for a childless wife was a closer question, but on balance Douglas thought there should be, in view of “the widely held belief that a wife’s chief duty lies in ‘making a home’ for her husband.”<sup>176</sup>

Douglas did not propose a phase-in of the credit, but he nevertheless intended it to be available only to the industrious; he stipulated that it would be paid “only to the families of men already employed, or, at the most, to these plus those that were laid off because of lack of work.”<sup>177</sup> Douglas rejected the idea of phasing out the allowance dollar for dollar as earnings rose above the minimum wage level (that is,

---

<sup>168</sup> Id. at ix.

<sup>169</sup> Id. at 41.

<sup>170</sup> Id.

<sup>171</sup> Id. (*italics omitted*).

<sup>172</sup> Id. at 217.

<sup>173</sup> Id. at 223.

<sup>174</sup> Id. at 211-14. Douglas considered and rejected the idea of varying the amount of the per child allowance according to the age of the child or the number of children in the household. Id.

<sup>175</sup> Id. at 210, 216, 222.

<sup>176</sup> Id. at 211.

<sup>177</sup> Id. at 261.

a phase-out rate of 100%): “Who would wish to work hard in an effort to increase his salary when, for every dollar which he added to it, a corresponding dollar would be deducted from the allowance paid to his family?”<sup>178</sup> Instead, he proposed a more gradual phase-out, under which the \$200 per child allowance would be decreased by \$20 for each \$200 of additional wages within the phase-out range.<sup>179</sup> Similarly, the \$250 spousal allowance would be reduced by \$25 for each \$200 of additional income. Analogizing the phase-out to a tax (which Douglas did not do), the resulting marginal tax rate in the phase-out range is a function of family size. For example, the rate would be 22.5% for a worker with a wife and one child, and 42.5% for a worker with a wife and three children.<sup>180</sup>

Douglas considered, but rejected, the Malthusian objection to family allowances. He concluded that “the increasing emancipation of women, the growing desire for higher and more expensive standards of living, and the diffusion of knowledge concerning birth control all combine to lessen the fear of an undue quantitative increase in the population which was cherished by an earlier and gloomier generation of economists.”<sup>181</sup> As a sop to latter-day Malthusians, however, he expressed a willingness to limit the allowances to a worker’s first four children.<sup>182</sup>

The most significant difference between Douglas’ proposal and the version of the EITC proposed in this Article is in the source and administration of the allowances. Instead of allowances paid and administered by the government, Douglas envisioned a group of employers forming a fund, to which all would contribute and from which allowances would be paid to the employees of all.<sup>183</sup> Each employer’s required contribution would depend on the number of its employees, rather than the number of its employees’ dependents, so employers would have no reason to resist hiring employees with large families. One of Douglas’ major arguments against government funding and administration reflects his failure to realize that a government allowance could take the form of a phased-in EITC. He assumes that a government-based program would have to take the form of a guaranteed minimum income, and so he objects that “the allowances . . .

---

<sup>178</sup> *Id.* at 221.

<sup>179</sup> *Id.* Douglas posited that, if the basic wage were \$800 a year, the wages earned could increase to \$1,000 a year without any reduction in benefit. The phase-out range would commence above that.

<sup>180</sup> Douglas did not consider the possibility of phasing out the allowances consecutively, rather than concurrently, so that workers with larger families would face a larger phase-out range rather than a higher phase-out rate.

<sup>181</sup> Douglas, note 151, at 255.

<sup>182</sup> *Id.* at 256.

<sup>183</sup> *Id.* at 42.

paid for the children of men who had voluntarily left their jobs . . . would lessen the incentives to work and encourage shiftlessness.”<sup>184</sup> He also assumes, contrary to experience with the actual EITC, that a government program “would give to the party in control enormous powers of patronage and prestige which would create an almost invincible political machine and would give the political bosses a means of disciplining recalcitrant and independent citizens.”<sup>185</sup>

---

<sup>184</sup> Id. at 218-19.

<sup>185</sup> Id. at 218.

